OVERSIGHT OF SMALL BUSINESS ADMINISTRATION'S SBIC PROGRAMS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

OVERSIGHT OF SMALL BUSINESS ADMINISTRATION'S SBIC PROGRAMS

DECEMBER 16, 1982

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December 16, 1982: Morning session 1

OVERSIGHT OF SMALL BUSINESS ADMINISTRATION'S SBIC PROGRAMS

THURSDAY, DECEMBER 16, 1982

U.S. SENATE,
SMALL BUSINESS COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 9:45 a.m., in room 424, Russell Senate Office Building, Hon. Lowell Weicker, Jr. (chairman of the committee), presiding.

Present: Senator Weicker.

Also present: Robert J. Dotchin, staff director; R. Michael Haynes, chief counsel; and Dorothy C. Olson, hearing clerk.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT, AND CHAIRMAN, SMALL BUSINESS COMMITTEE

The CHAIRMAN. The committee will come to order.

First of all, I want to apologize for starting the hearing late. It was due to certain administrative details. We are going to move right along.

This is the sixth in a series of oversight hearings the committee has held to examine the major programs run by the Small Business Administration, and today we will be looking at the small business investment company and minority enterprise small business investment company programs.

In recent months, these programs have been the subject of much controversy by the press and the public. Allegations of widespread abuse and fraud have been raised, and two reports issued by the Inspector General's Office have been critical of aspects of the SBIC and MESBIC programs.

Our purpose in meeting today is to take a good, long look at these two programs to get a better understanding of the abuses that have existed and the outlook for the future.

As chairman of the Small Business Committee, I am troubled by accounts in the press and from the Inspector General's Office that indicate that the program is laced with participants who have not operated their SBIC's or MESBIC's properly and have abused the program.

If this program is to continue to serve the very vital function that it has served over the past several decades, it is important that it operate effectively, without a taint of doubt of impropriety. I do not intend to allow this program, which has done so much in the past, to be victimized by an unscrupulous few.

We have with us today the Acting Inspector General for the SBA, who will discuss with us his findings as a result of an intensive study of the SBIC and MESBIC programs, SBA Administrator James Sanders, and representatives of the SBIC and MESBIC industry.

Because of the fact that there are going to be votes coming up shortly, which means that we are going to go a little beyond the times that I have indicated to the Administrator, and I know he has other engagements, I wonder, Jim, whether you would like to go ahead and give your testimony now. That way you can get back to the Small Business Administration without having to wait until around noontime, which is what I figure it would be if you waited until the end of the proceedings.

Mr. SANDERS. Thank you very much, Mr. Chairman.

The CHAIRMAN. Would you identify those who are with you, and then just proceed in offering your statement any way you deem appropriate.

STATEMENT OF HON. JAMES C. SANDERS, ADMINISTRATOR, SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY EDWIN T. HOLLOWAY, ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT, AND ROBERT G. LINEBERRY, DEPUTY ASSOCIATE ADMINISTRATOR FOR INVESTMENT

Mr. SANDERS. Mr. Chairman, thank you for this consideration. I am accompanied this morning by Mr. Holloway on my left, the Associate Administrator for Finance and Investment, and Mr. Lineberry on my right, the Deputy Associate Administrator for Investment who is in charge of the SBIC programs.

I would like to submit my statement for the record, Mr. Chairman, and just make some comments from that statement in the interest of time.

The CHAIRMAN. Your statement in its entirety will be included in the record.

Mr. SANDERS. Thank you, sir.

I think it should be said that this innovative program that we are discussing today has succeeded in providing unique and much-needed assistance to small business. Since its inception, nearly $4.5 billion of financial assistance has been provided to more than 66,000 small concerns which in turn have produced jobs, economic gains, and tax revenues far exceeding the Government's cost of operating the program. In the calendar year of 1981, 2,329 small businesses received $387 million of disbursements from SBIC's.

The benefits of this program are truly impressive. Companies such as Cray Research, Intel, Federal Express, Four-Phase Systems, are some of the examples of success. I think an important feature of this particular program, also, that sometimes goes unnoticed and unmentioned, is the human capital that has been developed over the last 25 years in the SBIC program. That is to say, the expertise of the financial entrepreneurs that operate the SBIC's is perhaps even more important to the Nation than the other resources of the program.

This program has developed venture capitalists in a successful way. The economy will reap a harvest because of the know-how that has been provided to many entrepreneurs, and that know-how has attracted many private capital dollars today that continue to flow to the small business venture capital market.

Now I think another comment that is important for us to consider in these deliberations is that most of the problems that have surfaced in violations, in flagrant violations, examples that we all should be concerned about, were surfaced by the SBA's Inspector General's department. That is part of the SBA's management system. They were not uncovered by the Secret Service or the FBI or anyone else. They were uncovered by the Inspector General of the SBA.

I think that the agency in this particular program has tried to act—and continues and will make redoubled efforts to act—in a manner which balances the need for adequate protection of the public interest against the need to not overly constrain an innovative, high-risk program—and it is a high-risk program, by its nature. Accordingly, there is some understandable tension among the SBA, its Inspector General, and other oversight bodies who feel that measures taken are not tough enough. On the other hand, these steps clearly amount to a sharpening of some policy and regulatory items that had been poorly defined and inconsistently administered, and have caused some necessary tension with the SBIC industry, which believes we have been too restrictive.

I think nothing positive, Mr. Chairman, comes from raising the heat of our rhetoric to a point where the facts are forfeited in the interest of individual gain, Government intransigence, or unnecessary public outcry. To its credit, the SBIC industry has fulfilled much of what all believe that the Congress intended by passing the Small Business Investment Act of 1958. The impressive record of investment and success stories is a tribute to those licensees who have worked with the SBA to achieve the goals for which the program was designed.

This program requires active management and constant attention to the balance of which I spoke. I do know that you will continue to hear from industry representatives and from others on all sides of the myriad issues involved in the complex business financing program. This dialog is important. It is important to us. There will always exist this kind of dynamic tension between the industry and our responsibilities for regulating the industry to see that those who are taking advantage of the public and the taxpayer are eliminated from it, while not penalizing those that truly perform under the guidance and for the purposes of this act as passed. We know that if it gets too quiet, then we all have to worry.

That concludes my remarks, Mr. Chairman. I might suggest that if Mr. Holloway has something to add, we can give him a few minutes.

[The prepared statement of Mr. Sanders follows:]

SBA U.S. Small Business Administration Washington, DC 20416

STATEMENT OF
JAMES C. SANDERS, ADMINISTRATOR
SMALL BUSINESS ADMINISTRATION
BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

DECEMBER 16, 1982

MR. CHAIRMAN AND MEMBERS OF THIS COMMITTEE:

I welcome this opportunity to come before your committee to discuss the status and future of the Small Business Investment Company Program. Accompanying me are Edwin T. Holloway, Associate Administrator for Finance and Investment and Robert G. Lineberry, Deputy Associate Administrator for Investment.

The SBIC Program, created by the Small Business Investment Act of 1958, is SBA's Pioneer Program combining private sector profit motive, expertise and resources with government financial incentives to provide long-term, high-risk debt and equity financing and management assistance to the Small Business Community.

PROGRAM BENEFITS

That this innovative program has succeeded in providing unique and much needed assistance to small businesses is beyond doubt. Since its inception, nearly $4.5 billion of financial assistance has been provided to more than 66,000 small concerns which in turn have produced jobs, economic gains, and tax revenues far exceeding the government's cost of operating the program. In calendar year 1981, 2,329 small businesses received $387.1 million of disbursements from SBICs.

The benefits of this program are impressive. They extend to workers, stockholders, customers, suppliers, and to society at large. Venture capital success stories on individual "winners" in which SBICs participated are many. Companies such as Cray Research, Intel Inc., Federal Express, and Four-Phase Systems, are prime examples. From a broader perspective, the results are creation and maintenance of employment, improvement of productivity, introduction of new products and processes into our economic stream, and most importantly perpetuation and reinforcement of entrepreneurial opportunity in the small business scetor.

SBA has, for the purpose of evaluation, tracked several probability samples of small business recipients of SBIC financing through their life cycle in the SBIC portfolio. We have found substantial improvements in the employment, sales, profits, and assets of these client firms. The sample of 100 small portfolio companies taken in 1973 shows after tracking these firms for six years that they increased employment, after deducting the effects of the failed companies, by 1,866 jobs after those six years. These 100 firms received initial SBIC disbursements of $12.2 million and benefited from an estimated $40 million dollar years of SBIC financing.

But of greater importance, an institutional source of venture capital now exists in the financial community as the result of the government's willingness to create such a program and its perseverance in this program through the bad as well as the good times. The human capital that has been developed over the last 25 years in the SBIC program is not often recognized but is nonetheless significant. That is to say, the expertise of the financial entrepreneurs that operate the SBICs is perhaps even more important to the nation than the other resources of the program.

An analogy may be drawn to a farmer who has rich, tillable soil and all the other factors necessary to raise a fine crop. If the farmer does not know when or how to plant and care for his land he will not harvest a crop in spite of how much seed and fertilizer is administered. This program has developed venture capitalists in a successful way. The economy will reap a harvest because the know-how has been provided to many entrepreneurs and that knowhow has attracted many private capital dollars that today continue to flow to the small business venture capital market.

PROBLEMS

It is important to keep in mind the dual nature of this program: investment activity conducted by the private sector on one hand and federal funding on the other. The federal funding imposes a duty upon both private sector participants and the SBA to ensure that program funds are used as intended by the statute and that the taxpayers' interest in receiving principal and interest repayment of those funds is protected.

The most serious matters reported to program officials by SBA's Inspector General usually involve deliberate misuse of funds, misrepresentations, and poor management by licensed small business investment companies. These problems, while not attributable to a major segment of the SBIC industry, cause us all great concern as do patterns of less serious violations which, while not criminal in nature, indicate a lack of responsibility on the part of some SBICs.

Besides the regulatory violations, another major area of concern is the increase in SBIC liquidation activity by the Agency. As of September 30, 1982, liquidation action completed resulted in charge-offs on 116 cases for $32,953,000 out of $70,094,634 due the government. In addition, as of the same date, there were another 117 active liquidation cases in which the principal balance due SBA totaled $150,127,244. We expect that losses on some of those cases could amount to another $75 million. To put the matter in perspective, the overall SBIC loss ratio amounts to about 7% of total funds disbursed to SBICs for the history of the program.

In a concerted effort to clear out the problems that blemish an otherwise fine program, SBA has undertaken a number of steps during the past two years. I would now like to direct your attention to the charts, which list these actions. Ed Holloway will now explain our activities to the Committee in greater detail.

CHRONOLOGY

Moratorium Initiated on April 17, 1981
Moratorium Lifted on August 6, 1981
Revision Six Published on August 16, 1982

ADMINISTRATIVE ACTIONS

LICENSING & TRANSFER APPLICATIONS

Closer Scrutiny & Evaluation

- Field Evaluation: Business Reputation and Need for New Licensee
- Management Experience
- Plan of Operation
- Diversified Investment Philosophy

APPLICATIONS FOR FUNDING

Tighter Credit Controls

- Idle Funds Level
- Investment Plan Required
- Overall Financial Condition
- Regulatory Compliance
- Elimination of Automatic First Tier Funding for MESBICs

NEW REGULATIONS

- Increase Minimum Capitalization
- Strengthen Inactivity Remedies
- Lengthen Minimum Financing Term
- Encourage Equity Investments
- Eliminate Insignificant Technical Violations

ONGOING AND FUTURE DEVELOPEMNTS

Improve Regulatory Oversight

- New System for Tracking Violations
- Reduce Frequency of Examinations on Non-Violators (Legislation)
- Increase oversight for Chronic Violators
- Firmer Stance on Repeated and Serious Violations

Program Promotion And Delivery

- Increase Field Office Promotion Efforts
- Develop Field Office "Matching" capability
- Educate Business Community

The Agency has tried to act in a manner which balances the need for adequate protection of the public interest against the need to not overly constrain an innovative, high risk program. Accordingly, there is some understandable tension among SBA, its Inspector General and other oversight bodies who feel the measures taken are not tough enough. On the other hand, these steps clearly amount to a sharpening of some policy and regulatory items that had been poorly defined or inconsistently administered, and have caused some necessary tension with the SBIC industry which believes we have been too restrictive.

These tensions are a healthy expression of our sometimes conflicting responsibilities and in my mind indicate we are moving towards achieving the balance of which I spoke. That this balance can be delicate is well illustrated by the idle funds problem described in the Inspector General's statement.

Some SBICs have maintained excess liquidity during the recent years of high interest rates to provide themselves a lucrative source of risk free profit through arbitraging low interest long term government funds against short term commercial and Treasury rates. However, at the other extreme, SBA has found a small number of SBICs who are so illiquid that they cannot meet their operating expenses, including servicing of existing indebtedness to the government, except by further borrowings from government. Because of this divergence in the cash positions and investment strategies of SBICs, SBA chose to strengthen its regulations regarding licensee inactivity but to deal with liquidity, or the lack of it, as a credit decision on a case-by-case basis. Generally this is tighter on both extremes. It requires increased small business investing on the part of licensees with excess liquidity if they are to retain their licensees and/or obtain additional government funding. It also means that a licensee who is so heavily into an unseasoned equity portfolio that its survival appears doubtful may receive funding only with caveats that require it and the SBA to monitor its financial condition more closely.

Another particular source of tension has been the proposed Revision 6 to the Rules and Regulations governing the SBIC Program. Undertaken at the SBIC industry's request, this comprehensive revision was developed over a two year period that included consultations with industry and an extensive clearance process within government. Published last August in the Federal Register, the proposal brought forth an onslaught of rhetorical "doomsday" reaction from industry leaders, even though SBA had signalled that this was a proposal and that we were very interested in receiving and reacting to responsible public comment. We also received many well reasoned objections from individual SBICs, and I am pleased to report that changes have been made in some eight items that drew major criticism as well as others where the objections were fewer numerically but nevertheless valid. Recent meetings with industry representatives to discuss the comments and changes indicate that an acceptable balance is apparently being struck.

From all of this, I believe you can deduce that SBA in administering this program is aiming to be firm but fair. Nothing positive comes from raising the heat of our rhetoric to a point where facts are forfeited in the interest of individual gain, government intransigence or unnecessary public outcry. This has unfortunately characterized much of the public debate in recent months surrounding this program. Where misstatements were made we have sought to correct them. Where the Agency's position was perceived as one of intransigence by industry representatives, we have sought a dialogue to clarify our position. When individual interest seems to have overridden public interests we have sought to correct these situations and have been firm in doing so. Happily, in the end it was the cooler headed participants who prevailed and we are moving forward together with the SBIC industry not only with better regulations but a better understanding of our mutual responsibilities.

To its credit, the SBIC industry has fullfilled much of what all believe the Congress intended by passing the Small Business Investment Act of 1958. The impressive record of investment and success stories is a tribute to those licensees who have worked with SBA to achieve the goals for which the program was designed. I believe that the process we have undergone and the measures we have taken will permit purging of the excesses from the program and enable it to be seen as the very model of private sector and government cooperation.

Our efforts will not result in all the diverse parties and interests finding a common ground on which we can settle with all issues resolved. This program requires active management and constant attention to the balance of which I spoke. I do know you will continue to hear from industry representatives and from others on all sides of the myriad issues involved in a complex business financing program. However, it will be because we are being diligent in our responsibilities to administer the program fairly but firmly. If it gets quiet, then you should begin to worry.

As customary, we stand ready to answer any questions you may have and again thank you for the opportunity to appear before this committee.

The CHAIRMAN. Thank you very much.

Mr. Holloway?

Mr. HOLLOWAY. Thank you, Mr. Chairman.

Mr. Chairman, in all of our finance programs at SBA, we are making a very determined effort to improve the administration of those programs. The SBIC program is certainly no exception.

We did have some charts prepared today to itemize for you some 20 or 30 items specifically that we are doing in this program to improve its administration.

The CHAIRMAN. I would like to see them.

Mr. HOLLOWAY. Mr. Chairman, as you are aware there was, by the former Administrator, a moratorium on new licensing in this program between April and August 1981. Growing out of the review of the program that took place at that time, a revised set of regulations was published in the Federal Register for comment on August 16, 1982.

I refer next to our attempts to tighten up the administration of the program. This starts with licensing actions and the transfer of certain licenses. We are giving closer scrutiny and evaluation to every licensing and every transfer of every license.

First of all, we have instituted a field evaluation, which uses our SBA district office or branch office, to surface information about the business reputation of the proposed licensees as well as the need for a licensee in that particular locality. We are looking closer at the management experience and insisting on a meaningful plan of operations, so that we can see exactly what this particular SBIC proposes to do in this program. We are looking to try to get diversified investment philosophies, rather than an SBIC that specializes in something, as an example, like taxicabs.

The next significant thing that happens after the licensing of an SBIC is generally the leveraging or funding applications of the SBIC. As I indicated to you, we are trying to do a more quality, professional job of assessing risk in all financial programs, and we are tightening up our credit controls under the program.

Now I will say that this is a very tough area, because while tightening up the assessment of risk, we still want to encourage this program in the direction of the venture capital financings as opposed to straight debt lending based on collateral. We are looking at the idle funds issue very closely, and where a licenser has excessive idle funds we will deny the leveraging and not fund it. When the applications come in, we want to see an updated investment plan for the utilization of those funds.

We look at the overall financing condition of the SBIC, and if in fact there are credit or regulatory problems that indicate to us that the financing should not be given until certain turnarounds have been achieved, then we will defer or deny the financing. Another significant step has been the elimination of automatic first tier leverage funding for MESBIC's. We are really requiring that a significant portion of the capital of the MESBIC be committed prior to providing additional funds.

The new regulations also take other significant steps—proposing an increase in minimum capitalization, strengthening of our remedies for inactivity. It is not very profitable for money to simply lie fallow in bank accounts and not be used for the avowed statutory purposes of the program. We have proposed a lengthening of the minimum financing terms, and are trying to move the program more in the direction of equity investments as opposed to straight debt investments, although it must be said that there are many valid instances in which long-term straight debt financings are very appropriate for the program.

Also, in the new regulations we hope to eliminate some insignificant technical violations, so that it is more for the substantial violations that we cite companies.

In trying to improve our regulatory oversight, the staff is also attempting the development of a new system for tracking and keeping up with the violations. We would like to reduce the frequency of examinations on nonviolators, and I believe that the Inspector General's Office has proposed that they examine SBIC's as a matter of requirement only once every 2 years instead of once every year, in order to spend less time on the SBIC's that are in full compliance and to have more time to spend on any problem SBIC's. We are taking a look at our possible actions for chronic violators, and trying to take a firmer stance on repeated and serious violations.

With respect to promoting the program, we would like to use our own field offices more in the promotion efforts, to carry the word, make known the availability of this type of financing. As the chairman appreciates, debt financing under our regular general business loan program, is a shoe that does not fit many financial needs. We need another shoe, and that shoe is the equity capital shoe. We would like to use our field offices to match up equity need with SBIC's and provide that particular need. That matching capability is being stressed in all of our management meetings. Of course, lastly, we would like to educate the business community more to the availability of this program and these benefits.

I would like to say, Mr. Chairman, that despite the problems of this program in the past, which we are making a mighty effort to resolve, we believe that this is a fine program. We know that the leadership of the SBIC industry shares our concern about the future of this program, and we are working with them in a constructive way to try to bring about some of the very needed improvements that we all recognize must be made.

The **Chairman**. Thank you very much.

I have no further questions at this time, Mr. Administrator. Those questions that arise during the course of the hearing that might be directed toward you, I will submit for a response to the record.

Thank you very much.

Mr. **Sanders**. Thank you, sir.

The **Chairman**. We will now have before the committee Mr. Raymond Randolph, the Acting Inspector General of the Small Business Administration.

Mr. Randolph, before sitting down do you want to raise your right hand?

Do you swear to tell the truth, the whole truth, and nothing but the truth, so help you God?

Mr. **Randolph**. I do.

The **Chairman**. Thank you.

Be seated. If you will state your name, proceed with your testimony in whatever way you deem fit.

Mr. RANDOLPH. I can read the whole statement, about 18 minutes, if that is not too much time, or I can try to brief it down by not including as many examples, whichever you prefer.

The CHAIRMAN. I think it important, probably, insofar as you are concerned, that the whole statement should be read, and you go ahead.

STATEMENT OF RAYMOND F. RANDOLPH, ACTING INSPECTOR GENERAL, SMALL BUSINESS ADMINISTRATION

Mr. RANDOLPH. I am Raymond F. Randolph, Acting Inspector General of the Small Business Administration.

Mr. Chairman and members of the committee, I am here at your request to testify concerning the examination and investigative experience of the Office of Inspector General with the Small Business Investment Companies in the investment program of the Small Business Administration.

The program was established in 1958 and has evolved into a system in which private investment companies are licensed by SBA and are eligible to obtain funds either from the Federal Financing Bank or the Small Business Administration. Before an investment company can obtain these funds, the company must have a minimum capital of $500,000.

Investment companies receive these funds at rates of interest close to or below that which the Government itself pays for money. The investment companies are obligated to use the funds obtained for equity investments and long-term capital loans to small and disadvantaged small businesses.

The benefits of this program to the licensees are deliberately attractive to encourage investors to lend to small businesses. The record of our examinations and investigations of the companies in the program, however, also shows unmistakeably that its benefits have attracted some unscrupulous criminal elements as well.

I want to be careful at this point to note that the SBIC program is not rampant with fraud, corruption, or maladministration. Any program like this where large amounts of money and the freedom to invest it are the predominate characteristics, unscrupulous operators will attempt to take advantage of the program. SBA must find ways to make these attempts at fraud riskier and less lucrative to the unscrupulous licensee, without hindering the operation of the other licensees who are attempting to serve the intent of the program.

The focus of my remarks will be on what we perceive to be the nature of the findings we note in the course of our examinations, the possible causes of the consistent rate of these findings, and possible solutions to some of our findings. First, I would like to describe and illustrate by actual case examples findings which we consider to be serious.

The first category is conflicts of interest. These occur most frequently when an associate of a licensee is or appears to be in a position to benefit either directly or indirectly from a financing or related transaction with a small business concern in other than an arm's length or approved manner.

Examples: A licensee advances $500,000 to its parent and subsidiary for use in their lending operations. A licensee provides $216,000 in financing to its parent company, an amount equal to 38 percent of its private capital, to pay operational expenses of the parent. A licensee provided a $60,000 loan to a small company whose director and owners were associates of a second licensee. Simultaneously, the principals of the second licensee made a $60,000 loan to a small concern owned by the officers and directors of the first licensee. In effect, what could not be done directly was accomplished as a result of collusion by these two licensees.

Excess interest rates: This occurs when a licensee exceeds a permitted rate of interest. These increases are oftentimes hidden charges or prohibited indirect costs charged to small businesses, such as finders fees, consulting fees, management fees, stock options, et cetera.

Examples: A licensee misled the agency into believing that profit participation provisions had been removed from two loan agreements, when they were not. As a result, the licensee collected excess profits of more than $215,000 from small businesses.

A licensee made financings to 24 small businesses containing provisions which would have resulted in excess cost of money if the firms had exercised the option to prepay. In one case the licensee charged a $100,000 nonrefundable loan origination fee, in addition to an annual rate of 18 percent. A first-year prepayment would have resulted in a 38 percent per annum interest rate.

One case illustrates the persistence of some licensees. In 1980 we determined that a licensee had developed financing arrangements with 17 small concerns which placed him in a position to charge all but one concern 24 percent interest. The one other firm would have paid 40 percent. The SBA advised him by letter that these arrangements were prohibited and must be precluded. During our next examination in 1981, we noted that the prior differences had been cured but the licensee had developed a new way to gouge small businesses. In 28 financings, he had charged the companies management and other fees which effectively raised the interest higher than that permitted by regulation.

Prohibited use of funds: This occurs when a licensee makes investments not permitted under program regulations, for example, financing to real estate firms, foreign firms, and relending firms.

Example: A licensee provided equity financing to a firm primarily engaged in obtaining wagering income for the operation of a horse racing track, a violation of the regulations prohibiting investment in gambling operations.

A licensee provided $100,000 to a small concern whose owner was an 80 percent owner of a nonresidential building whose only source of income was derived from tenant rents. The proceeds of the financing were used to purchase the building.

A licensee provided financing to a small concern which used the entire proceeds of the loan to purchase goods from a supplier which was an associate of the licensee providing the funding.

A licensee made a $100,000 personal loan to the president of a financed small concern for the purchase of a personal residence.

Control over portfolio concerns: This occurs when a licensee assumes other than temporary control over a firm, rather than assisting a firm through provision of equity funds.

Examples: Two licensees acquired 66⅔ percent of the common stock of a small concern without having filed a divestiture plan for approval by the SBA.

A licensee effectively obtained control over a small concern through its ownership of 27 percent of the firm's voting stock. The remaining shares were spread among 50 other stockholders.

A licensee and its associates acquired a 96 percent interest in a small concern in connection with a $650,000 financing consisting of $550,000 in notes and a $100,000 common stock purchase. The same licensee also assumed control over two other small concerns by purchasing 80 percent and 100 percent of their issued and outstanding stock.

Lending limitations exceeded: This occurs when a licensee exceeds a prescribed percentage of private capital in a financing without first securing approval from SBA. Without special approval, a licensee may generally invest only 20 percent of its capital in any single concern.

Examples: Even after SBA had provided special permission to exceed the 20-percent limit, a licensee exceeded the new limit by $165,000. As a result, more than 33 percent of the firm's total capital was invested in only one concern.

A small licensee provided nearly 50 percent of its total capital to a small concern. Based on agency action, the licensee was precluded from making further financings but, in an effort to keep it viable, subordinated its debt so that the small concern could acquire financings from other sources. Eventually the firm could not support its debt, went bankrupt, and the licensee wrote off the debt of $270,000.

Other prohibited activities: This finding occurs when a licensee engages in activities not specifically permitted in the regulations, such as financing to large businesses or other activities not in the public interest.

Examples: A licensee provided $150,000 financing to a small business, $100,000 of which was used by the company's secretary to purchase rental property for her personal benefit.

A licensee made two financings to an inactive small concern which used the proceeds to pay the living expenses of the licensee's associate.

A licensee made an equity investment in a concern which did not appear to qualify as a small business by virtue of the fact than an affiliated concern, in a position to control the small concern, had 22,218 employees.

A licensee made a sizable donation to a charitable organization which was an associate of the licensee.

An interesting thing about these findings is that the percentage of companies with these findings changes very little from year to year. For example, in the most recent semiannual report the rate was 41 percent.

The Office of Inspector General turned its attention to this persistent rate of findings in 1980 when we issued a special survey report of the SBIC program. In that survey we examined the actions taken by program officials in the Investment Division to effect corrective action by the licensee. What we found at that time was an institutional pattern of waivers of violations, and some systemic causes.

I can report that the conditions described in the survey have improved. Communication between the Office of Inspector General and the Investment Division is greatly improved, and the decision has recently been made by the SBA to reconstitute the practice of sending cases of violators to hearing examiners where judicially enforceable orders and agreements can be obtained.

In addition, the Office of Inspector General participated in the revision of the regulations for this program and the Investment Division was responsive to a number of our recommendations and concerns. It is too soon to tell whether or not these changes will have an effect on reducing the rate of findings.

Mr. Chairman, I would also like to point out that during the course of our examinations, we also detect situations which appear to violate Federal criminal law and which require more than administrative actions. When this occurs, the cases are referred to the Investigations Division of the Office of Inspector General. Presently, there are 11 SBIC's under investigation for possible criminal acts. There are also 16 cases pending final action either by SBA or the Justice Department. The following are some of those investigations.

A corporation obtained an SBIC license without any initial capital investment, on the basis of representations made by the principal and others. The SBIC received $1 million in leveraged funds, a substantial portion of which the principal converted to his own use or benefit.

Specifically, he used $250,000 to purchase a luxury yacht, deposited $82,000 to his personal checking account, and purchased a personal certificate of deposit for $200,000. The principal also made personal loans of $70,000 to friends, repaid a delinquent bank loan of $19,000 for a company owned and controlled by the principal. Through the device of phony financing, the principal diverted $75,000 for the down payment on a personal residence.

As a result of the investigation, the principal was indicted and pled guilty on charges of mail fraud and false statements, and was sentenced to 3 years imprisonment plus 5 years of probation to be served consecutively. He was also required to make restitution to SBA in the amount of $1 million.

The SBA provided $1 million to another licensee, in financing to an SBIC after the principals misrepresented that they had invested $500,000. An investigation disclosed, however, that no private paid-in capital was invested. The principals used the agency's money for their own benefit and the benefit of other members of their family.

The case was presented to the grand jury after an investigation of the corporation by the U.S. Attorney's Office and SBA. The principals entered a guilty plea to three counts of defrauding the Government and received the following sentence: a $1,000 fine; requirement to pay $1 million to the agency; a 3 months' jail sentence; and 5 years on probation.

Another example: Principals of an SBIC embezzled $225,000 and concealed it as an investment in two small businesses. Principals of the small businesses then passed the cash back to one of the SBIC principals. This person commingled the $225,000 with $75,000 from another source and deposited the total with a bank for credit to the licensee's account. The $300,000 deposit was represented to SBA as an increase of private capital and was parlayed into $900,000 of leveraged funding. The principals have surrendered the SBIC license and repaid all amounts owed SBA, over $3 million including interest.

A licensee received a license after falsely representing to SBA that it had $1 million in private funding available for investment. The examination and investigation prior to providing the $1 million in Government funding disclosed that the principal of the licensee had a notorious international reputation and was known by several aliases. He is presently wanted for questioning in connection with fraud and check kiting schemes in two European countries, was convicted and sentenced in Paris, France, on worthless check charges in 1967, and is now under investigation by authorities of another European country for worthless check schemes. In the United States he provided information to a State licensing authority to the effect that he had $1 million on deposit in a bank. The claim proved to be false.

Another concern of the Inspector General was expressed in October 1981, in the IG's management advisory report on the topic of idle funds and inactivity in the SBIC program. The purpose of this report was to focus the SBA's attention to the large amount of program money lying idle in the hands of SBIC's and not invested in small businesses. We did identify two principal causes, that is, ineffective regulation and relative ease of obtaining Government funds. Action taken to establish need for funding and action planned to monitor idle funds, including revised regulations, should reduce this problem.

There remain two of our recommendations toward further elimination of the problems related to inactivity and idle funds which the program office has disagreed with. The first recommendation suggested a change to SBA's fundings procedure to a transactional procedure. That is, applicants for Government funds would have to specify the uses in advance for requested funds and certify to those uses. This would remedy the current situation where licensees do little more than supply a forecast of their intentions regarding the use of funds, and may then retain the funds in certificates of deposit or banks if they change their minds for any reason. The second recommendation suggests that substantially all idle funds be invested in Treasury obligations.

In conclusion, I believe the Office of Inspector General is doing a more than adequate job of examining the SBIC program. However, we would like to see passage of S. 2408 which would give us the prerogative to examine licensees every 2 years instead of every year. This would free those SBIC's who consistently have an excellent regulatory record from the requirement and expense of an annual examination, and allow the Office of Inspector General more flexibility to more closely monitor problem companies.

Mr. Chairman, that concludes my prepared statement. I would be pleased to respond to any questions.

The **CHAIRMAN.** Do you feel that your office and/or whatever department of the agency is in charge of enforcement is adequately staffed in relation to either the problems out there or the potential of problems? In other words, strictly in terms of personnel, do you have enough personnel to do an adequate job?

Mr. **RANDOLPH.** Well, we have to take into account the constraints of the budget in everything that we are trying to do in the Federal Government today. We could always use more people. I believe that we could use additional people but, again, it is a very difficult question to answer.

The **CHAIRMAN.** No, it isn't, because I am not sitting here as the Budget Committee. I am the Small Business Committee. It is up to other people to go ahead and devise the budget. It is up to this committee to provide the proper oversight of, in this case, the Small Business Administration.

Therefore, exclude any budget constraints—which is not the problem of this committee—I would only repeat the question: Do you feel that you do have adequate personnel to properly monitor the moneys that are out there in the SBIC/MESBIC field?

Mr. **RANDOLPH.** I would say that we could use a few more people, say 10 or 15 more. I think we could do a better job at that level.

The **CHAIRMAN.** In February 1980, the Inspector General's Office, under the former Inspector General, Paul Boucher, issued a report entitled: "A Special Survey of the Small Business Investment Company Program." This report, which I have before me, I will now introduce as part of the hearing record.

Also the Southern Investment and Funding Corp. audit and investigation, Sagera Venture Corp., Finevalor Capital Corp., the Feyca Investment Co., and First Capital Corp. audits and investigation reports will all be submitted into the record at this point.

Also, the Inspector General's management advisory report on idle funds and activity will be made part of the record.

[Material follows:]

REPORT ON
A SPECIAL SURVEY
OF
THE SMALL BUSINESS INVESTMENT
COMPANY PROGRAM

OFFICE OF INSPECTOR GENERAL
U.S. SMALL BUSINESS ADMINISTRATION
FEBRUARY 1980

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I. SUMMARY OF FINDINGS AND RECOMMENDATIONS

A special survey has been conducted by the Office of Inspector General (OIG) of 1,016 reports of examinations on Small Business Administration (SBA)-licensed small business investment companies (SBIC's) over a three-year period from July 1976 to June 1979. During that survey, this Office developed a profile of the findings of statutory or regulatory violations reported by our auditors, with particular reference to significant violations of SBA Rules and Regulations. Based upon that profile and approximately 14 years of annual SBIC examination experience, we have developed recommendations which we believe would enhance the management of the SBIC program as a whole, and permit SBA to deal more effectively with potential and actual violations of Federal statutes and regulations governing program operations.

As of August 31, 1979, there were 413 licensed, operating SBIC's in the program.[1] At the conclusion of the fiscal year ending on September 30, 1979, a total of $728 million in Federal funds committed to operating SBIC's for investment in small businesses was outstanding, including $93 million committed to SBIC's established for the purpose of investing in minority small business concerns. During the same fiscal year, commitments of Federal funds to SBIC's had increased by $100 million, the largest single yearly increase since the program began in 1958. Over the three-year period surveyed for this report, an average of 42% of the operating SBIC's examined were cited for significant violations of SBIC program rules and regulations. If the integrity of this important SBA program is to be maintained and improved, we have concluded as a result of our review that action in the following major areas should be considered or initiated.

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[1] By January 30, 1980, that number had increased to 438.

A. PROCEDURES GOVERNING THE CONFIRMATION OF PRIVATE CAPITALIZATION SHOULD BE STRENGTHENED

In order to confirm the existence of statutorily required levels of unrestricted private capital injections into SBIC's, we urge that consideration be given to adoption of procedures by which SBA, or cooperating financial institutions, would act as temporary, pre-licensing trustees or escrow agents for the private capital of applicants for SBIC licenses. In the alternative, SBA should adopt a requirement for bank confirmations of the availability of unencumbered capital, with appropriate warnings as to the effect of false statements. Further, we believe that consideration ought to be given to a requirement that documentation up to and including financial statements be obtained from SBIC officers, directors, and principal stockholders attesting to the source and status of their private capital contributions. Our review has also disclosed that while certain valid criteria are applied in connection with first tier leveraging requests by SBIC's, certain elements of these criteria requiring prescribed levels of financial investment in or commitments to small businesses should be more precisely defined and extended to leverage applications from minority enterprise small business investment companies (MESBIC's).

B. ACTION DESIGNED TO IMPOSE SANCTIONS AND REDUCE REGULATORY VIOLATIONS SHOULD BE INSTITUTED

Our review indicated an apparent pattern of reliance upon the examination letter as a corrective measure after findings of statutory or regulatory provisions have been reported in the examination reports. Given the broad range of administrative sanctions available to the Agency, we believe that recourse solely to the comparatively mild examination letter has diluted its effectiveness over the course of time. We believe, too, that it contributes to a sense of security on the part of SBIC officers that significant and even repeated violations of the Small Business Investment (SBI) Act and SBA Rules and Regulations will not subject them to any sanction more severe than the letter.

Lack of an effective follow-up to regulatory violations, including prescription of well-defined corrective measures and concerted efforts to enforce compliance when necessary, undermines the integrity of the program. We have urged, therefore, more judicious use of the examination letter as one sanction in a range of sanctions available to the Agency. In addition, we believe that consideration ought to be given to development of an additional regulatory tool incorporating a so-called "reverse leveraging" concept. Such a regulation would permit the Agency to reduce the amount of money an SBIC could obtain in leverage funds after violation of or in connection with waivers of specified program regulations. Such a sanction could serve as an incentive for more earnest efforts by SBIC's to comply with significant regulations. We also propose that SBA take advantage of its opportunities to communicate with SBIC's in Agency and industry publications, through which the industry could be alerted to significant regulatory problems, enforcement actions and legal issues.

C. ORGANIZATIONAL CHANGES WITHIN THE INVESTMENT DIVISION ARE WARRANTED

Our study leads us to believe that the Agency should act to resolve inherent conflicts between the Investment Division's present licensing, financing, regulatory and promotion functions. The conflicts generated by these competing interests--a continuation of problems articulated in 1971 by the General Accounting Office (GAO)--could be effectively reduced or eliminated through the creation of a separate, independent regulatory enforcement unit under the cognizance of the Associate Deputy Administrator for Programs. This independent unit would be empowered to oversee all Agency responses to findings of potential or actual violations of program regulations by SBIC's. It would also be the unit responsible for initiating remedial or enforcement actions, and for reviewing and approving requests for additional leverage funds by SBIC's found to have violated specified program regulations. In addition to alleviating existing conflicts between present Investment Division functions, we believe that the implementation of this concept will enhance objectivity, assure consistency and serve as a deterrent to future violations.

D. THE SCOPE AND CYCLE OF SBIC AUDIT ACTIVITIES REQUIRE EXPANSION

Due to the expanded nature of our audit responsibilities in recent years, certain measures are discussed in this report which are necessary in order to discharge those responsibilities. These include adoption by the Agency of a requirement that SBIC's obtain authorization from portfolio concerns for audit access to the books and records of the concerns. In any event, now and in the future, recourse will be had in appropriate cases to the subpoena power of this Office in order to discharge our audit responsibilities under the SBI and Inspector General Acts. Further, we have concluded that the one-year examination cycle should be changed and expanded to a two-year cycle. Expedited action to achieve legislative approval or to provide additional audit personnel is urged if this Office is to be able to comply with the mandates of the statutes governing the operations of this Office and the SBIC program.

E. AGENCY ACTION IS REQUIRED IN OTHER PROGRAM AREAS

Our study leads us to believe that improvements could be made in a variety of other program areas. In response to comments from a number of SBIC officers, we suggest that SBA consult with the Minority Business Development Administration (MBDA) of the Department of Commerce to assure that advice provided by that Office to prospective SBIC licensees is in accord with the intent of the SBI Act and SBA Rules and Regulations. In order to more effectively communicate SBIC program practices and policies to both SBA personnel and SBIC's, we recommend development of standard operating procedures governing Agency administration of the SBIC program, and the institution of formal training programs for SBIC applicants. Finally, we suggest that consideration be given to formation of a regulatory review panel comprised of Agency and industry representatives to make any such revisions of existing program regulations as might be warranted.

II. INTRODUCTION AND BACKGROUND

At an Audit Committee meeting several months ago, there was considerable discussion between the Administrator and the Inspector General about the effectiveness of the Agency's management of the Small Business Investment Program. In general terms, discussion centered around the nature and scope of Agency oversight and regulation of SBIC's and of the role played by the Office of Inspector General in this activity. At that time, audit experience with respect to the various types of significant regulatory findings was outlined, as was the nature of the remedial actions usually undertaken by the Investment Division to correct deficiencies noted during annual examinations.

As a result of this discussion, this Office undertook a special study having as its objective the development of general recommendations for program changes which would improve the Agency's ability to prevent, detect, and remedy violations of rules governing the operation of SBIC's. It was decided that this study would be based primarily upon experience with major regulatory violations--the so-called "significant six" violations. While these were the focus of the study, the findings and recommendations contained herein have broad application to a range of program functions.

It is believed that the recommendations contained herein strike a proper balance between the responsibility of SBA to fairly and effectively manage and regulate a most important program and the need for

SBIC's to operate effectively in a reasonably regulated environment in furtherance of their efforts to perform the service intended by Congress when it enacted the Small Business Investment (SBI) Act.

III. THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

A. PURPOSE AND DEVELOPMENT OF THE PROGRAM

The Small Business Investment Act of 1958 empowers SBA to license privately owned and operated SBIC's established for the purpose of providing equity capital and long-term loans to small business or portfolio concerns, including minority enterprises.[2] As a rule, SBIC's must be capitalized initially by private investors, after which they are eligible to receive additional funds known as "leverage" or "leveraging" from the Government or from private financial institutions in the form of Government-guaranteed loans for investment in small business concerns.

As of August 31, 1979, OIG records showed a total of 413 active, licensed SBIC's subject to the annual examination requirement of the Act. The table which appears on the following page reflects levels of private capital and Government financing to those 413 SBIC's by reference to their ownership arrangements:

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[2] The SBIC's investing in minority enterprises are generally known as MESBIC's. References to SBIC's in this report should be understood to include MESBIC's, unless otherwise noted.

SBIC Ownership	SBIC's	SBIC Private Capital (In Millions)	SBA-Provided Leverage (In Millions)
Individually Owned	185	$141.7	$162.7
Nonfinancial Institution	99	100.3	127.4
Bank Dominated	56	174.8	131.8
1940 Investment Act Company	31	95.4	163.2
Financial Organization Other Than Bank or Bank Holding Company	27	47.2	62.0
Bank Associated	15	19.6	21.8
	413	$579.0	$668.9

B. MANAGEMENT OF THE PROGRAM

1. Regulation of Small Business Investment Companies

The responsibility both for licensing and regulating SBIC's operating under the SBI Act rests with the Investment Division, under the direction of the Associate Administrator for Finance and Investment and the Deputy Associate Administrator for Investment. As part of its administration of the SBIC program, that Division authorizes direct or guaranteed Government financing of SBIC licensees. It acts upon all applications from licensees for SBA approval in advance of transactions requiring such approval under SBA Rules and Regulations--e.g., variations in officers, directors, or 10 percent or more stockholders in connection with proposed changes of control; changes in capital structure; and mergers, dissolutions, or surrenders of licenses. In connection with the transactions described, the Investment Division undertakes to determine that the surviving company meets prescribed licensing standards and that SBA's credit position is protected. In addition to these functions, the Division is responsible for determining that violations of the SBI Act or SBA Rules and Regulations have been committed by licensees, proposing appropriate courses of remedial action and undertaking actions to enforce compliance.

2. Examinations of Small Business Investment Companies

Pursuant to Section 310(b) of the SBI Act, SBIC's--except those in receivership or in liquidation--are subject to an annual examination requirement. In 1978, the Office of Inspector General assumed the responsibility formerly exercised by the Office of Audits and Investigations for the conduct of these examinations, the purposes of which are to determine whether the SBIC's are adhering to the statutory and regulatory requirements and whether their financing practices conform to the procedures required or approved by SBA. At the conclusion of each SBIC examination, an examination report is prepared which summarizes the audit findings including, where relevant, details of matters which in the judgment of this Office constitute violations of the letter or spirit of the SBI Act, SBA regulations or of any agreements or understandings between the SBIC and SBA.

In cases wherein a report discloses possible violations of Federal criminal laws, the matter is referred to our Office of Financial Investigations and Examinations. In all other cases, the examination reports are issued and referred to the Office of Finance and Investment for further action. That Office then reviews each examination report and makes its own determination (sometimes after consultation with the Office of General Counsel) as to what, if any, statutory or regulatory violations may have occurred. It then issues an examination letter to the SBIC, notifying it of the violations identified by that Office, and either requesting further information or prescribing corrective action to be taken by the SBIC.

C. SIGNIFICANT REGULATORY VIOLATIONS

Experience with examinations of over 1,100 SBIC's licensed since 1958 has led to a definition generally accepted by the Investment Division, this Office, and the SBIC industry of six SBA regulations, violations of which are regarded as major or significant. These "significant six" regulations are listed below, with citations to the sections of Title 13 of the Code of Federal Regulations (CFR) at which they appear, and brief descriptions of the means by which violations of the regulations may occur:

1. Maximum Annual Cost of Money /13 CFR 107.301(c)/

Violations of this regulation, the principal SBA rule limiting the cost of money, occur when SBIC's realize or attempt to realize returns in excess of 15 percent per annum on funds invested in small business concerns. Various arrangements may be used both to levy and to conceal these extra costs, including monthly amortization payment plans, unauthorized management service agreements, fees and discounts, and more complicated "put" and "call" agreements.

Ninety-six violations of this regulation have been reported by OIG auditors in the past three years.

2. Overline Limitation /13 CFR 107.301(d)/

This regulation is violated when an SBIC invests an amount exceeding 20 percent (30 percent, for a MESBIC) of its paid-in capital and paid-in surplus in a small business and any affiliated concerns. The violation frequently occurs because SBIC's omit affiliated concerns from their computation of the 20 or 30 percent limit, or because additional financings are made to a small concern after initial investments were made which met SBA limits.

One hundred and twenty violations of this regulation have been reported by OIG auditors in the past three years.

3. Control of Small Concern /13 CFR 107.901/

Violations of this regulation occur when SBIC's or an SBIC and its associates, by means of management agreements, voting trusts, majority representation on a board of directors, majority ownership of stock or other arrangements, exercise control of a portfolio concern without a planned divestiture. Often, violations of this regulation are reported in connection with so-called "capital manipulations" described in Section V(A) of this report.

One hundred and twenty-six violations of this regulation have been reported by OIG auditors in the past three years.

4. Prohibited Use of Funds /13 CFR 107.1001/

Among possible violations of this regulation are financings made by SBIC's to small business concerns for their use in real estate speculation or rental transactions, purchases of goods from suppliers associated with the SBIC's, certain relending or reinvestment activities, foreign investments, or for stock purchases or other capital investments in the SBIC's. Violations of this regulation are routinely reported in connection with capital manipulations when, for example, funds are invested in the portfolio concern for its use in discharging an indebtedness incurred by the SBIC.

Ninety-one violations of this regulation have been reported by OIG auditors in the past three years.

5. Conflict of Interest /13 CFR 107.1004/

This regulation prohibits all forms of self-dealing prejudicial to a small concern, the licensee, its shareholders or partners, or to SBA. Violations occur when, for example, an SBIC insider enjoys or appears to enjoy a privileged or preferred position in the licensee's financing activities, when small concerns are required to provide unauthorized compensation to an associate of the SBIC, or when an SBIC finances its associates. This violation, too, is generally cited in connection with capital manipulations.

Two hundred and thirty-three violations of this regulation have been reported by OIG auditors in the past three years.

6. Activities Not Contemplated /13 CFR 107.803/

SBIC's may violate this regulation in any number of ways, the most common violation occurring in connection with financings made to companies which do not meet the size standards for small businesses prescribed by the Small Business Act of 1958 and outlined in Part 121 of SBA regulations. Activities conducted in connection with capital manipulations are violations of this regulation.

One hundred and twelve violations of this regulation have been reported by OIG auditors in the past three years.

D. ENFORCEMENT OF REGULATORY CONTROLS OVER SMALL BUSINESS INVESTMENT COMPANIES

The rules governing SBA's enforcement of regulatory controls over SBIC's and their officers are derived from the SBI Act and codified in regulations at Part 110 of CFR Title 13. In addition to the examination letters referred to in Section III(B)(2) of this report, numerous enforcement mechanisms for willful or repeated violation by an SBIC of the Act or regulations are available to program officials, including the following:

1. call of the entire indebtedness upon default;
2. issuance of a cease and desist order;
3. suspension or revocation of the SBIC license;
4. application for temporary or permanent injunctions or restraining orders or other court orders;
5. suspension or removal of directors or officers of a licensee;

6. application for appointment of trustee or receiver to hold or administer assets of a licensee; and,

7. imposition of monetary civil penalties (fines).

IV. SCOPE OF REVIEW

This Office has completed a special study of significant regulatory control problems encountered in the operation of the SBIC program. Its purpose was to develop recommendations which, if implemented, would enhance the management of this most important program and permit the Agency to respond more effectively to violations of Federal statutes and regulations governing program operations.

The bases for this special survey were the 1,016 SBIC examination reports issued during the period of July 1976 to June 1979, together with the accumulated years of first-hand examination program experience of Inspector General personnel. This survey included review and evaluation of the findings contained in those examination reports, with findings defined as apparent violations of Part 107 of SBA's Rules and Regulations. The survey concentrated on the violations of the six significant regulatory provisions outlined in Section III(C) of this report, specifically: maximum annual cost of money, overline limitation, control of the small concern, prohibited uses of funds, conflict of interest, and activities not contemplated by the SBI Act. Special attention was given to those six regulations in view of the general perception that they are central to the implementation of the Act, and because violations of them recurred regularly during the period of time covered by this review. The remainder of this report presents a discussion of relevant findings and our recommendations for appropriate responses to them.

V. FINDINGS AND RECOMMENDATIONS

A. PROCEDURES GOVERNING THE CONFIRMATION OF PRIVATE CAPITALIZATION SHOULD BE STRENGTHENED

Examinations by SBA auditors during the past three years have disclosed a number of cases in which the initial levels of private capital required to be present in an SBIC prior to funding by SBA were not in fact available for use due to undisclosed encumberances or restrictions. The devices by which SBIC's effect the appearance or illusion of unemcumbered, unrestricted private capital available for investment in small business concerns vary, but are generally referred to in this report as "capital manipulations."[4]

One of the most important prerequisites of any business is a sound, adequate capital base. Over the years, SBA had endeavored to encourage the development of such substantial private capital bases by recommending that applicants for SBIC licenses have available a minimum private paid-in capital and paid-in surplus of at least $500,000, rather than the legal minimum of $150,000. A recent amendment to the SBI Act, which took effect on October 1, 1979, raised that minimum to SBA's recommended $500,000 level. Upon achieving a minimum private capital base of $500,000, licensed SBIC's become eligible for Government funding in the form of what is known as "leverage" or "leveraging."

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[4] While it is this aspect of the term "capital manipulations" which is focused on in this report, the term is also applied to various uses of SBIC funds after leveraging which violate or otherwise fail to comport with the purposes of the Act. Capital manipulations would, for example, encompass depletions of an SBIC's capital--through unauthorized financings to associates or other previously described prohibited activities--so as to justify requests for additional leveraging.

Leverage, one of the single most attractive features of the SBIC program, is the financial assistance provided to a licensee by SBA either by the purchase or guarantee of debentures or by the purchase of preferred securities. SBIC's are eligible to receive long-term leveraging of up to four times the amount of their available private capital up to a maximum of $35 million, at interest rates a fraction above the rate paid by the Government for the use of the money. Still greater incentives are provided to MESBIC's which are licensed to invest exclusively in minority enterprises. While regular SBIC's must commit 65 percent of their funds to venture capital financings in order to qualify for the fourth dollar of leverage money, MESBIC's need only commit 30 percent of their funds.

This prospect of long-term Government financing or leveraging which becomes available to an SBIC after licensing becomes a significant incentive for the creation of an appearance or illusion of available private capital ready for investment into small concerns. Given the incremental commitments of public dollars which SBA is prepared to make to qualified SBIC's, it would seem incumbent upon the Agency to undertake substantive measures to assure that the foundation upon which these commitments are made--i.e., private capital--is what it purports and is required to be: unencumbered and unrestricted. Existing policies and procedures should be strengthened in order to provide such assurances.

For example, our examinations indicate that SBA has been misled in some cases as to the availability of an SBIC's private capital by reason of representations made by members of the banking community.

Another deficiency in the present system of regulatory controls occurs in connection with the first tier leveraging practices applied to MESBIC's. In order to detect any possible fraud by means of capital manipulations by SBIC's, examinations of an SBIC are routinely made within six months of licensing or upon receipt of the first request from the SBIC for leveraging. In general, Investment Division practice--in the absence of rules and regulations defining a uniform set of guidelines--is to provide this first tier of leveraging to SBIC's other than MESBIC's only after 65 percent of their funds available for investment have either been invested or committed to be invested in small business concerns. No standard governing the form or degree of the commitment (as opposed to the actual financing) made to a small business concern has been developed by SBA. The lack of such a standard permits vague, potentially unsupported commitments of money to be figured into the 65 percent threshold. Such commitments do not provide satisfactory assurances as to the present availability of statutorily prescribed levels of private capital required for SBA funding.

Conceptually, however, the 65 percent financing criterion presently applied in connection with the initial SBIC leveraging request affords the Agency an opportunity to assess the extent to which and the manner in which the SBIC's funds have been actually available for investment in small business concerns. As a practical matter, though, current program requirements in connection with private capital availability do not suffice to assure that capital manipulations or other serious problems will not exist, or that the initial examinations will be able to detect the existence of such problems.

The situation is further aggravated in the case of MESBIC's which may apply for the first tier of leveraging prior to the making or commitment of any financing to small businesses. The initial examination in connection with a MESBIC's first leveraging request must be made, therefore, in a comparative vacuum--i.e., without the benefit of experience to indicate whether and to what extent MESBIC funds were available for and applied to small concerns.

RECOMMENDATIONS

1. We believe that the single most effective mechanism for confirming the existence and availability of the private capital of SBIC license applicants would be a temporary, pre-licensing transfer of that capital to SBA or cooperating financial institutions as trustees or escrow agents. This trustee relationship could commence at a designated point in the licensing process and continue until such time as the SBIC is licensed and begins operations. So as not to impede legitimate financings prior to licensing to small businesses which would qualify after licensing as portfolio concerns, private capital funds would be subject to release upon a showing by the SBIC that the financing was being made for a purpose and in a manner consistent with the SBI Act. While we recognize that implementation of this proposal could require some additional staffing, we believe that--in addition to providing reliable assurances as to the availability of the initial capital injection by the applicants for SBA licenses--it would have the advantage of reducing the incentives or opportunity for fraud, collusion, manipulation of assets or other

improprieties by the applicant in connection with its required investment, and could deter potential applicants from attempting to reap the tremendous benefits of the SBIC program without the capital base required both by the SBI Act and SBA Rules and Regulations. In the absence of a decision to adopt this proposal, however, we recommend implementation of the following alternative measures.

2. In order to provide adequate assurances as to the availability of an SBIC's required private capital, this Office recommends the development and use of a standard bank confirmation form requiring a representation by an officer of the depository of private SBIC funds to the effect that the funds are free from encumbrances and restrictions. Such a form should incorporate appropriate warnings with respect to sanctions attendant upon the making of false statements.

3. We further recommend the adoption of a requirement that principal SBIC stockholders document the sources and status of their capital contributions, and consideration of an additional requirement that all officers, directors, and 10 percent or more stockholders of an SBIC submit financial statements to SBA. Any documentation submitted pursuant to such requirements should contain warning notices concerning the effects of false statements. Such reporting requirements would materially advance SBA's ability to assure that its commitments of substantial amounts of public money are based upon the available private capital contributions that are not only desirable, but required by law.

4. In view of the Investment Division's present practice of allowing commitments of financings to be considered in connection with SBIC applications for first tier leveraging, we recommend the development of more precise definitions of the types of commitments which will be accepted and included within the 65 percent ratio. We believe that such definitions are necessary if SBA is to assure itself that commitments represent the actual, not illusory, availability of private capital contributions.

5. We recommend also that serious consideration be given to an extension to MESBIC's of the criterion presently applied to SBIC's by which first tiers of leveraging are only considered after investments or well-defined investment commitments of prescribed ratios have been made to the small business concerns. The extension of this criterion to MESBIC's would afford the Agency and OIG examiners the opportunity to assess the extent to which the MESBIC's private capital base has been actually available for investment.

B. ACTION DESIGNED TO IMPOSE SANCTIONS AND REDUCE REGULATORY VIOLATIONS SHOULD BE INSTITUTED

While annual examinations of licensees have cited numerous regulatory violations of varying degrees of significance, this survey concentrated on a review of examination reports which contained findings expressing OIG's judgment that the SBIC had violated one or more of the significant six regulations for the three-year period from July 1976-June 1979. The table below is a profile of those reports:

	7/1/76-6/30/77	7/1/77-6/30/78	7/1/78-6/30/79	Totals
SBIC Examination Reports Issued[3/]	347	325	344	1,016
Reports Containing Significant Findings	145	147	131	423
Percentage of Reports with Significant Findings	42%	45%	38%	42%
Number of Significant Findings				
Conflicts of Interest	75	88	70	233
Control Over Portfolio Concern	50	35	41	126
Overline	55	29	36	120
Activities not Contemplated	39	40	33	112
Excessive Interest Rate	34	32	30	96
Prohibited Use of Funds	26	32	33	91
Total Number of Findings	279	256	243	778

[3/] Reports issued during yearly periods indicated equate with companies reviewed.

With respect to the 344 SBIC's examined from July 1978 to June 1979, a total of 593 regulatory findings were reported, attributable to 254 companies, or 74 percent of those examined. Of those 254 companies, 131 (or 52 percent) had one or more findings of significant regulatory violations.

As the table indicates, reports on the 1,016 SBIC's examined from July 1976 to June 1979 cited at least one significant finding in 423 cases--or 42 percent of the total. Furthermore, 182 of those reports--or 18 percent of the total--contained more than one such finding. Analysis of the 423 reports with significant findings disclosed that 39 SBIC's with such findings during the 1978 examination cycle were determined to have either the identical or new significant findings during the 1979 examination cycle. The following table identifies the nature of the significant findings attributed to these 39 SBIC's during the 1978 and 1979 examination cycles:

Significant Findings	Recurring Violations (1978-1979)	New Violations (1979)
Control Over Portfolio Company	11	6
Conflict of Interest	10	10
Overline	8	4
Excessive Interest Rate	7	4
Activities Not Contemplated	7	8
Prohibited Use of Funds	4	4
Total Number of Findings	47	36

We believe that this history of regulatory findings can be attributed to a number of causes. Based upon regular and recurring contact with SBIC officers over many years, auditors have perceived a noticeable indifference towards the outcome of the annual examination and the prospect that they might be cited for possible violations of program rules and regulations. This attitude is most evident among the more established SBIC's whose officers are familiar with SBA's program management practices.

In our view, this attitude arises out of a perception by these seasoned SBIC managers that their one time or even repeated violations of a significant regulation will not result in the imposition of the sanctions discussed in Section III(C) of this report against them individually or against the licensee. Conversely, they perceive that violations can be committed with relative impunity and with no substantive negative impact on either the SBIC or its associates except, possibly, in situations involving potential insolvency or ultimate financial loss to the SBA. We would note that certain actions by an SBIC which might otherwise be regulatory violations may be undertaken with prior SBA approval or waiver of regulations. Some SBIC managers, however, perceive the approval process--rightly or wrongly-- as a time consuming and burdensome process and so avoid attempting to obtain SBA authorization.

In either case--i.e., violation of SBA regulations with or without cognizance of possible approval procedures--a significant number of SBIC officers can feel secure in their perception that the only adverse effect of knowing regulatory violations, significant or otherwise, will be protracted letter writing or other communications in response to Investment Division examination letters urging them to correct any deficiencies found in the OIG examination. This sense of security is evidently not unwarranted in view of the fact that only three administrative hearings under the SBI Act are reported to have taken place in 14 years, with the last hearing said to have been held in April 1974.

Regulations governing the SBIC program are designed to enable licensees, with substantial borrowings from the Federal Government, to provide the maximum level of assistance to small business concerns of this nation. They are also intended to ensure the sound management and integrity of this financially attractive program. Mere regulation alone without meaningful enforcement is inadequate to preclude regulatory violations. In our view, a less than aggressive pursuit of violators of these regulations, especially those regulations most crucial to the integrity and success of the program, will have the effect of contributing to significant program abuses.

RECOMMENDATIONS

1. The OIG recommends that a review of SBA's past enforcement practices be undertaken in order to ascertain how sanctions available under the law, but not effectively utilized for over 10 years, may be implemented to ensure that a timely and forceful response is made to companies found to be in violation of significant regulatory provisions. The examination letter procedure, now virtually the only enforcement device used by the Investment Division, should be reviewed

in an effort to identify those situations in which that procedure would be the most appropriate response in a range of possible responses to regulatory infractions. Use of the letter to correct all deficiencies, from the de minimis to the significant, must be discontinued since it has the effect of diminishing the perceived gravity of even the most serious violations. Our recommendations on the manner in which regulatory enforcement should be managed and administered are the subject of discussion later in Section C of this Report.

2. We further recommend that serious consideration be given to the development and implementation of a regulation based upon a concept of "reverse leveraging." The purpose of such a regulation would be to reduce the amount of funds an SBIC could obtain through the leveraging process when it is found to be in violation of certain well-defined, major program regulations.

The primary incentive for being a licensed SBIC is the statutory and regulatory authority permitting such entities to seek long-term borrowing of up to four times the amount of their private capital at basically the same rate the U.S. Treasury pays for its money. The SBI Act and SBA regulations spell out the upper limit of leveraging, but nowhere is there any language restricting an SBIC's ability to obtain the maximum allowable leverage. Naturally, judgments as to the capability of SBIC managers, the soundness of their investments and the like are important when leveraging is being considered. However, we also believe that the extent to which an SBIC complies with the SBI

Act and SBA regulations--especially the "significant six"--is of equal if not greater importance to the leveraging process. Adoption of appropriate regulatory provisions implementing a "reverse leveraging" sanction would put SBIC's on notice that violations of identified regulations would automatically reduce their ability to obtain leveraging for a stated period of time and in no case, until after the firm involved had been found to be in full compliance with all program rules and regulations.

3. In addition to the foregoing, we believe that as an adjunct to the strengthening of our enforcement procedures, SBA should take steps with the National Association of Small Business Investment Companies (NASBIC) to signal to the industry SBA's concern over violations of its regulations and to seek its active support in strengthening the program. For example, the SBA quarterly publication, the "SBIC Digest" could be expanded to discuss particular regulatory problems, abuses, and various enforcement actions being taken by the SBA and the Department of Justice. We noted a change in the most recent issue of the Digest in which six pages were devoted to legal issues. We believe that the use of the Digest in this manner is important and should measureably enhance its value to the industry. Likewise, the SBIC newsletter published by NASBIC could be used to communicate information concerning regulatory problems and alert the industry to SBA's views on regulatory matters. Increased use of these two publications could be of significant value in educating the industry and foster a closer adherence to rules designed to achieve program objectives.

C. ORGANIZATIONAL CHANGES WITHIN THE INVESTMENT DIVISION ARE WARRANTED

Under SBA's present organizational structure, SBIC promotion, licensing, financing, and regulation functions are conducted by a single entity under the direction of the Associate Administrator for Finance and Investment. At one time, the annual examination of SBIC's was also a function performed by the Investment Division. This practice was severely criticized by GAO in a report entitled, "Further Improvements Needed in Administration of the Small Business Investment Company Program," issued July 21, 1971. Among other considerations, GAO viewed this practice as a significant conflict of interest. GAO, therefore, recommended the removal of the examination function from the control of the Investment Division so as to separate program administration from program oversight responsibilities and to promote increased objectivity in the performance of those duties. Contemporaneously with the publication of the GAO report, the examination function was transferred to what is now the Office of Inspector General.

This realignment went only part of the way, however, towards achieving a separation of inherently inconsistent Investment Division functions. Under the present arrangement, upon conclusion of an annual SBIC examination the report is sent to the Investment Division for its review. That Division--responsible initially for the licensing, financing and promotion of all SBIC's, including those SBIC's which are the subjects of the examination reports--is then in the position of having to evaluate the examination findings of possible significant and other statutory and regulatory violations. In the majority of cases during the past three years at least, its responsibility has been to acknowledge that violations have occurred--and in 39 cases during 1978-1979, have recurred--during the period of time that the SBIC in question has been under the supervision of the Investment Division. Even more problemmatic is its responsibility for deciding whether and in what way to impose sanctions upon the very SBIC's that it promotes. Program officials are presently free to waive regulatory violations, disregard them, or to initiate corrective action through examination letters or the range of sanctions described in Section III(D) of this report. Whatever its course of action, the Investment Division is placed in a position in which objectivity must compete with other program interests. Were this conflict--the same management problem cited nearly 10 years ago by GAO--to be resolved, we believe that more meaningful sanctions than the examination letter would be utilized. Furthermore, use of administrative hearing procedures more often than the three times reported in 14 years might tend to encourage greater compliance by SBIC's with their statutory and regulatory obligations.

Even in connection with the examination letter, we have detected something less than aggressive exploration and follow-up of audit findings. Examination letters purporting to describe examination findings are routinely sent to SBIC's in the absence of any prior coordination with OIG. Our experience has been that from time to time, examination letters either do not address all the findings in the examination reports or adopt interpretations of statutory or regulatory provisions about which this Office has significant differences of opinion or interpretation. In addition, this Office has not been provided as a matter of course with advance notice of proposed measures to resolve examination findings. This too, has resulted in resolutions of our findings with which we are in substantial disagreement. These practices have served at best, to generate confusion in SBA and the SBIC industry and at worst, to undermine the effective identification and resolution of real--but correctable--problems in the SBIC program.

A new basis for concern has arisen with the revision of OMB Circular A-73 announced on December 3, 1979, mandating follow-up on all findings by Government auditors within a maximum of six months, and establishing procedures for resolution of major disagreements between audit personnel and program personnel responsible for acting on audit recommendations. In order to assure timely follow-up on our findings and to permit meaningful negotiation of any disputed resolutions of those findings, this Office will now require that copies of all examination letters and notice of all proposed actions to resolve examination findings be provided to us by the Investment Division for comment prior to transmittal of such letters or actions to the SBIC's.

RECOMMENDATIONS

1. It is strongly recommended that a relatively small, separate organizational entity be established under the aegis of the Associate Deputy Administrator for Programs, which unit would be responsible

for direction and coordination of all corrective or enforcement actions undertaken in response to findings of possible regulatory violations in the SBIC program (and any other program where the conflicts previously described may exist) including but not limited to those reported in the annual examinations. Under this proposal, such a unit would have the authority on a continuing basis to monitor compliance by SBIC's with the SBI Act and SBA Rules and Regulations. It would be responsible for the development of examination letters which would adequately address the findings cited in the annual examination reports, and for assuring that such letters and proposed resolutions of examination findings are reviewed in advance by OIG. In addition, this unit could serve as an independent arbiter designated by the Administrator pursuant to revised Circular A-73 to resolve major disagreements between Investment Division and OIG audit personnel concerning examination findings and recommendations. Properly staffed, the unit would be empowered to direct the initiation of remedial or enforcement actions and, when appropriate, and in conjunction with the Office of General Counsel, would institute administrative action against licensees before an Administrative Law Judge at the Office of Hearings and Appeals. Funding requests from SBIC's which have been cited for or found to be in violation of specified SBA regulations could be reviewed by this unit and its concurrence obtained before final approval of the request by program officials. It could also be responsible for determining whether and under what conditions waivers of Agency regulations would be appropriate.

We do not expect that creation of such a unit would entirely eliminate differences of opinion between the unit, the Investment Division and this Office regarding regulatory interpretations, the gravity of regulatory violations or the appropriateness of all remedial or enforcement actions. We do believe, however, that implementation of this concept would serve three important functions: (a) it would permit more neutral, objective appraisals of SBIC (or other SBA program) regulatory violations and determinations of remedial measures; (b) it would assure consistency in Agency responses to actual or potential violations by SBIC's regardless of the region or area in which they might be situated; and (c) the existence of an entity within the Agency capable of responding independently to regulatory violations, especially the most serious ones, would be likely to have a measurable deterrent effect on SBIC officials. We recognize that this approach would be a dramatic departure from past practice. However, when raised informally by representatives of this Office with SBA officials at various levels, the concept has generally been regarded as a sound management suggestion.

We note that the recommendation that a separate enforcement unit be established was made by the Office of Audits and Investigations in its report on the results of an internal audit of SBIC regulatory activities dated February 28, 1977. That report (Number 7-77) contained significant information bearing upon the problems associated with regulatory enforcement by the Investment Division. To the extent that the findings and recommendations in that report are consistent with those in the instant report, they are incorporated by reference herein.

2. We recommend that procedures be implemented at the earliest possible opportunity for forwarding of copies of all examination letters to OIG for our comment prior to transmittal of those letters to SBIC's. Further, procedures should be established for provision of notice to OIG of all proposed corrective actions within a reasonable time prior to the initiation of those measures. The implementation of these procedures is necessary to enable us to comply with the mandates of revised OMB Circular A-73 and the Inspector General Act.

D. THE SCOPE AND CYCLE OF SBIC AUDIT ACTIVITIES REQUIRE EXPANSION

In order to more effectively assist SBA officials in carrying out their management and oversight responsibilities in the SBIC program, an expansion of the scope of OIG audit activity is necessary. As a result of the expansion of audit activity and the ever-growing number of licensees entering the SBIC program, an extension of the statutorily mandated one-year audit cycle is also necessary.

By way of background, audits conducted of SBIC licensees have been limited to a review of the books and records of the licensees. Based on examination results, letters of confirmation are sent to portfolio companies to verify financings made by the SBIC. Portfolio concerns are visited where appropriate and possible, and interviews are conducted with managers of the financed concerns. Portfolio concerns, however, are not required by regulation to submit to interviews or to make their books and records or, in appropriate cases, those of their financial institutions, available to the Office of Inspector General, notwithstanding the fact that the concern may have obtained hundreds of thousands of dollars generated by SBA leveraging.

Continued reliance upon voluntary access is inappropriate in a program of the dimensions involved here. Portfolio companies engaged in questionable activities inconsistent with the SBI Act or other Federal laws are unlikely to accede willingly to Federal examinations of their books and records. The integrity of the entire SBIC program rests not only upon our ability to monitor compliance by the SBIC's themselves. It depends as well upon our capacity for assuring that the portfolio concerns are the kinds of companies being assisted in the kinds of ways envisioned by the SBI Act. Additional safeguards to assure obligatory access in appropriate cases must be employed if this Agency is to fulfill that responsibility.

With the enactment of the Inspector General Act of 1978, this Office has the authority to issue subpoenas for books, records and other materials in connection with the audits and investigations which we conduct. In effect, therefore, this Office has a mechanism by which the books and records of financed concerns, including their bank records, can be obtained and reviewed in connection with SBIC examination activities. To members of the public and the business community, the service of a subpoena may carry with it a negative connotation regardless of assurances to the contrary. The possible misunderstandings or embarassment attendant upon the use of subpoenas could be avoided were SBA to require that provisions for audit access be incorporated into financing agreements between SBIC's and their portfolio concerns.

The statutory one-year cycle for SBIC examinations poses additional problems in connection with the depth of audit coverage. At the present time, there are 438 licensees subject to examination. During the past six years, commitments of Government funds to SBIC's have risen from $450 million to about $750 million, with concomitant increases in requests for pre-leveraging and other special reviews.

Audit resources have been strained further by the need to audit annually both idle and active SBIC's, those without previous or recent regulatory violations and those with chronic regulatory control problems. To the extent that these increasing demands upon our audit resources--needed also for audits of other major SBA programs--are not resolved on a timely basis, this Office will be placed in the untenable position of being unable to comply either with the statutory annual examination requirement, or with our equally important responsibilities under the Inspector General Act.

RECOMMENDATIONS

1. It is recommended that regulations be developed which would require that SBIC's obtain waivers or authorizations from portfolio concerns as conditions of financing, which waivers would permit access by the OIG to the books and records of those concerns. We urge promulgation of such regulations at the earliest possible opportunity. With such regulations, the necessity for resort to OIG subpoenas will be markedly reduced. Absent such regulations now and in the future, this Office intends to exercise its subpoena authority in appropriate cases to obtain access to books and records of portfolio concerns in connection with the annual examinations. In our view, this is the only alternative measure by which to enhance SBA's ability to prevent and detect improper or collusive and fraudulent activities of the sort and magnitude alleged to have been detected recently.

Lest this recommendation for audit access authorizations be interpreted by some as a significant overreaching by the Government, it should be understood that the exercise of these audit prerogatives by the Office of Inspector General will not result in blanket audits of all portfolio concerns. Rather, such audits will be made in discrete, appropriate cases as part of further, in-depth examinations to determine or confirm that financing activities have been carried out in compliance with Federal law and program rules and regulations. Absent unusual circumstances, we will request that portfolio concerns voluntarily permit access to their books and records. Whether access is effected with such permission, pursuant to authorization in financing agreements or by means of an OIG subpoena, examinations of portfolio concerns will be undertaken judiciously and in furtherance of our responsibilities under both the SBI and Inspector General Acts.

2. We further recommend that significant numbers of additional personnel be provided to the OIG, or that legislative action be sought to extend the current one-year SBIC examination requirement to a two-year period so as to permit more thorough examinations. Legislative authorization of a two-year cycle would free this Office from the burden of annual audits of idle SBIC's, or of those with satisfactory histories of compliance with program rules and regulations. Such a cycle would also have the advantage of being sufficiently flexible to permit increased concentration upon examinations of SBIC's with persistent regulatory problems and those with substantial commitments of Federal funds. Timely legislative or other action is required if this Office is to adequately carry out its responsibilities in this most important SBA program.

E. AGENCY ACTION IS REQUIRED IN OTHER PROGRAM AREAS

1. Activities of Other Government Agencies Affecting the SBIC Program Should be Reviewed

The OIG has been informed by SBIC and MESBIC officers during the course of our examinations that representatives of other Government agencies have, on occasion, advised them of or facilitated means by which the initial pre-licensing private capital requirement may be satisfied--but only technically. We have been told, for example, that representatives of the former Office of Minority Business Enterprise (now the Minority Business Development Administration) of the Department of Commerce have counseled that temporary commitments of private capital may be made solely for purposes of SBA leveraging without a corresponding intent to apply that capital towards financings of small businesses.

The availability of private capital, available and intended for use in investments in small business concerns, is one of the central premises of the SBI Act. Provision of the advice described above by representatives of the Department of Commerce to prospective licensees is of concern to us, inasmuch as it would appear to be inconsistent with one of the primary purposes of the Act.

RECOMMENDATION

Appropriate action should be instituted to evaluate the nature and scope of the promotional activities of MBDA so as to ensure that such activities, either intentionally or unintentionally, do not lead to program abuses. If the facts are as reported to the Office of of Inspector General, this matter should be addressed at the earliest possible opportunity. In any event, we believe that ongoing coordination of promotional activities affecting SBIC's by SBA, the Department of Commerce and other Government agencies (including but not limited to the Community Services Administration) should be maintained.

2. Investment Division Standard Operating Procedures Should be Developed

It has become apparent to this Office over a period of time that program policies have evolved which govern critical features of the SBIC program. Some of these policies have already been discussed, such as the 65 percent standard for portfolio concern financings by SBIC's prior to authorization of the first tier of leveraging. However, with the exception of standard operating procedures (SOP's) governing interviews with prospective SBIC officers and applicants for SBIC financing (SOP 10 01), handling of SBIC applications and reports (SOP 10 02), processing and handling of examination report findings (SOP 10 03), and SBIC liquidations (SOP 50 53), no SOP's exist governing SBA's administration of the substance of the program. No SOP's exist, for example, defining procedures for private capital verification or first tier leveraging requirements. We believe that such critical operations ought to be guided internally by well-defined, standard procedures of general application to all SBIC's to assure consistency and certainty in the supervision of these operations.

RECOMMENDATION

We recommend the development of SOP's governing the entire range of SBIC program operations to serve as a single reference point for internal Agency policies and to promote consistent applications of those policies.

3. Review of SBA Regulations Should be Considered

Some SBIC officers have expressed a desire to participate in a review of certain rules and regulations which, they believe, no longer further the purposes of the SBI Act, do not adequately adjust for variant economic conditions, or could use clarification--those, for example, dealing with overlines, conflicts of interest, and cost of money.

RECOMMENDATIONS

We suggest that consideration be given to convening of a regulatory review panel as part of an ongoing process by which SBA, OIG, and SBIC industry representatives would identify those regulations which are insufficiently flexible, need clarification or strengthening, or no longer advance the purposes of the Act.

4. SBIC Training Procedures Should be Strengthened

Some SBIC officials have attributed some of their operating problems to inadequate training procedures--a complaint voiced most often by new licensees who say they received their first intensive training at a NASBIC-sponsored course a year or more after licensing.

RECOMMENDATION

We recommend that consideration be given to more formalized Agency training and education programs for SBIC license applicants as a condition of licensing, with some form of testing and written acknowledgment by the licensee of a basic understanding of program rules and regulations. SBA cannot and should not expect NASBIC to discharge this Agency's responsibility of apprising licensees of their obligations and responsibilities under the SBI Act and SBA Rules and Regulations.

INVESTIGATION

of

SAGERA VENTURE CORPORATION, INC.
BLOOMINGTON, MINNESOTA
LICENSE NO. 05/05-5121

[illegible]

OFFICE OF FINANCIAL INVESTIGATIONS
OFFICE OF INSPECTOR GENERAL

JULY 1980

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ATTENTION

Action taken or to be taken on the information contained in this report must be reported to the OFFICE OF INSPECTOR GENERAL, Attention: Assistant Inspector General for Investigations, within 30 days of the issue of the report.

This investigation was made in accordance with the policies and procedures contained in SOP 90 22 3.

Information contained in this report is to be disclosed only to responsible SBA personnel on a "need to know" basis. Disclosure of information to other than SBA personnel must not be made without the approval of the Inspector General and may only be done in compliance with the Freedom of Information Act (5 U.S.C. 552), and the Privacy Act of 1974, where applicable, as implemented by Agency policy, regulations, and SOP's (40 03, 40 04) and 18 U.S.C. 1905.

This report is issued by the Office of Financial Investigations, OFFICE OF INSPECTOR GENERAL.

Approved:

Marvin P. Shelton

Marvin P. Shelton, Director,
Office of Financial Investigations

Date JUL 17 1980

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REPORT ON INVESTIGATION
OF
SAGERA VENTURE CORPORATION, INC.
Bloomington, Minnesota
(License Number 05/05-5121)

INTRODUCTION AND SCOPE

The Office of the Inspector General, Office of Financial Investigations, made an investigation of Sagera Venture Corporation, Inc. (Sagera Venture), a Section 301(d) Small Business Investment Company (MESBIC). The purpose of the investigation was to determine if Sagera Venture or persons associated with the licensee had violated provisions of the Small Business Investment Act of 1958 and/or regulations relating to the Act. Specifically, the ommissions in the licensee's books and records that were disclosed during an Agency examination as well as the particulars of numerous undocumented financings were reviewed in greater detail. The investigation was made pursuant to authority set forth in Section 310(a) of the Small Business Investment Act and as authorized by Section 6(a)(2) of the Inspector General Act of 1978.

The investigation included a review of Agency operations files on the licensee, a review of available books and records of Sagera Venture and interviews with the President of the licensee and principals of portfolio small business concerns.

Various other third parties were interviewed, where appropriate.

As of June 30, 1979, Sagera Venture reportedly made 14 separate financings to various small business concerns. Of these, 13 were selected for review in order to confirm reports which Sagera had submitted to the Agency and in order to trace and determine the eventual use of licensee funds.

The results of the investigation have been discussed with an Assistant U.S. Attorney for Minnesota who has indicated the Department of Justice would consider pursuing the possible Title 18 violations that were disclosed.

SUMMARY

Gerald A. Stone, President of Sagera Venture Corporation, Inc. (Sagera), may have conspired with John U. Rykert, Senior Vice President of the Second National Bank of North Miami (SNBNM), Antonio A. Sobral, Jr., Leonard J. Lansburgh and others to defraud SBA by means of obtaining a license for Sagera to operate as a Section 301(d) Small Business Investment Company (MESBIC) and by inducing the Agency to advance $500,000 as initial leverage funding to the licensee. In furtherance of the above, the services of the U.S. Postal System as well as those of a telephone were employed in submitting possible false statements to the Agency in order to influence it to issue a license to Sagera on April 5, 1978, and to advance $500,000 to it on May 5, 1978. The investigation disclosed that Gerald A. Stone had not invested any funds in the applicant licensee and that Sagera had no funds or activity in any account at SNBNM prior to receipt of funds from SBA on May 5, 1978, all of which was contrary to the numerous representations and verifications made by Mr. Stone and others to SBA. As a result, Sagera obtained a license to operate as a Section 301(d) MESBIC without the private capitalization investment as required by the Small Business Investment Act of 1958, as amended, and it began its lending operations in June 1978 with borrowed funds derived and secured by an equity capital base funded solely by SBA, thereby denying that Agency of its lawful right to a proper administering of the Small Business Act as mandated to it and intended by Title 15 United States Code Section 661, et seq.

Gerald A. Stone and John U. Rykert may have conspired with Thomas P. Gray, Kent R. Ellison and Mel Sorem to defraud and deceive SBA by making material false statements and entries in books and reports that were submitted to the Agency. The investigation disclosed that during SBA's initial examination of Sagera's books and records in October 1978, but unknown and unreported to the Agency, Sagera Venture became the beneficial recipient of three 31-day personal loans totalling $525,000 taken by Messrs. Gray, Ellison and Sorem from SNBNM. The proceeds were used to purchase a certificate of deposit at that bank in the name of Sagera Venture Corp. for a 31-day period which was then represented by Mr. Rykert as being a security investment of Sagera at the bank, thereby concealing and deceiving SBA with respect to the shortage of cash and equity capital which had been created by an undisclosed payment of $525,000 to Leonard Lansburgh on May 16, 1978.

Gerald A. Stone may have conspired with Antonio A. Sobral, Jr. and Leonard J. Lansburgh to defraud SBA by submitting false statements to the Agency regarding fees paid in connection with the preparation of Sagera's application papers for licensing and the application for initial leverage funding. It had not been reported or disclosed that Leonard Lansburgh had received $25,000 as repayment for a fee he had advanced to the Interamerican Marketing Association of which

Mr. Sobral was the Executive Vice President, on behalf of Sagera Venture. The investigation disclosed the $25,000 repayment was made from the leverage funding that had been advanced by SBA to the licensee on May 5, 1978.

Gerald A. Stone and Mark Cram may have conspired to deceive and embezzle SBA funds by means of the possession of false papers and by making false misleading statements intended to deceive the Agency with respect to a $150,000 financing represented as having been made to M.C. Investments in July 1978. Mark Cram would not discuss any aspect of the loan or confirm any of the portfolio financing documents maintained by Mr. Stone in the licensee's files which, in part, included promissory installment Notes in the amounts of $140,000 and $10,000 signed Mark Cram. The investigation disclosed the $140,000 had originated with a loan taken by Sagera Venture from the Second National Bank of North Miami that was secured and eventually repaid by the certificates of deposit purchased directly with SBA leverage funds, which had been obtained by Sagera and Mr. Stone by means of a series of possible false statements and verifications submitted to SBA through the U.S. Postal System. Mr. Stone used the $140,000 to open a corporate savings account at the Bank of Minneapolis and Trust Company, and used that account to collateralize and eventually pay off three loans that were used for purposes not reported to SBA. The first loan was for $75,000 and was used as a down payment on Gerald Stone's personal residence in Edina, Minnesota, that was purchased in the name of Stephanie Ann Stone, and which was the location of a telephone through which numerous interstate and foreign telephone calls were placed and then billed to Gerry Stone, in care of Woodhill SoDak Corp., at the same business address as Sagera Venture. Other calls were placed to areas where Sagera Venture had purported lending activities. The second loan was in the amount of $36,000 and was deposited into the Riverside Community State Bank where Mr. Stone maintained a personal checking account. The third loan was for $32,500 which was deposited into a St. Paul bank where Sagera Venture was not a customer. Of the $150,000 total represented as having been loaned to M.C. Investments, the $10,000 balance was apparently deposited into an account controlled by Mark Cram. A financial report, certified by Gerald Alan Stone, that was submitted and received by SBA through the U.S. Postal System on September 26, 1979, described the above financing as an equity interest investment of Sagera. The report was submitted as part of the support of an application to influence SBA to purchase $500,000 of Sagera's preferred stock.

Gerald A. Stone may have conspired with Eugene Vacanti and others to make false and misleading statements and reports to SBA regarding the elimination from Sagera's portfolio of ineligible financings made to CHA Good Sports

Company, Inc. ($50,000) and Gale Bonaventure Associates ($150,000). The investigation disclosed the above two financings were not eliminated as was represented by Mr. Stone in correspondence submitted in response to the Agency's comment letter on Sagera's initial audit and in connection with Sagera's application for a second leverage funding of $500,000. In order to conceal the non-repayment of the ineligible financings, false and fictitious financing reports as well as other documents, were maintained in the licensee's files to represent financings made to two other small business concerns in the same amount as those reportedly eliminated.

Gerald Stone may have conspired with Steven Schmidt, Thomas Roe and John Henrikson to defraud and embezzle SBA funds by making false statements and representations regarding a reported equity financing of $150,000 to Seville Leasing Company on June 21, 1978. The investigation disclosed that $150,000 had actually been loaned to Clayton Management, Inc. (CMI) and deposited into its account at a bank in Hopkins, Minnesota, from which a wire transfer withdrawal was then made transferring $50,000 to a Woodhill So-Dak Corp. account at a bank in Sioux Falls, South Dakota. The $100,000 balance appears to have been used by CMI in a computer leasing business.

Gerald A. Stone possibly embezzled SBA funds and defrauded SBA by converting to his own use and benefit a substantial portion of the $500,000 in leverage funds advanced to Sagera Venture by the Agency on February 16, 1979. Various portfolio financing reports as well as general journal and ledger entries were generated by the licensee to represent financings purportedly made to small business concerns, as well as showing a certificate of deposit that had been invested as idle funds. Of the $500,000, the investigation disclosed Mr. Stone used $187,000 to purchase a yacht, $82,000 was deposited into various personal checking accounts of Mr. Stone's, some of which was used to outfit and equip the yacht for deep sea fishing, and $200,000 was used to purchase a certificate of deposit which was used to collateralize at least one unreported loan for $50,000 to a personal friend of Mr. Stone's. A second unreported loan of $20,000 was also made which when repaid was deposited into a personal account of Mr. Stone's, in a Minneapolis Bank and substantially wire transferred to another personal account in a Florida bank against which a payment of $18,923.20 was made to a Minneapolis law firm for payment of a delinquent bank loan of Woodhill Corp. In order to conceal the above transactions which were initially conducted through the use of official bank checks drawn on the Second National Bank of North Miami, no records were retained by Mr. Stone in the licensee's portfolio files other than those for the purported SBC financings.

Gerald Stone may have defrauded SBA by submitting possible false statements regarding the licensee's financial data as of December 31, 1978. It had been represented that financings were made to Flynn, Inc. ($150,000) and Executive Airways ($150,000) in December 1978 and to Robert Lloyd, Inc. ($126,000) in October 1978. The information was included in the financial data considered by the Agency when it approved Sagera's application for additional funding of $500,000 on February 12, 1979, and was included in a financial report submitted and received by the Agency's Investment Division through the mails. The investigation disclosed financings were not made to Flynn, Inc. and Executive Air and that Robert Lloyd, Inc. had only received financing of $9,000 from Sagera Venture as of December 31, 1978. Kathleen Flynn, a notary public, may have aided and abetted in concealing the above by signing licensee records that were reviewed by an Agency auditor to evidence the purported $150,000 financing to Flynn, Inc.

SBA advanced Sagera Venture initial leverage funds of $500,000 on May 5, 1978. Of that amount, the investigation disclosed $25,000 was used to repay Leonard Lansburgh for an unreported compensation fee which had been advanced by him on behalf of Sagera Venture in April 1978, and $5,000 was credited to the licensee's operating account at the Second National Bank of North Miami (SNBNM). The $470,000 balance was used to purchase renewable certificates of deposit (C/D) at SNBNM which were assigned as security and used for eventual repayment on 6 of 10 loans totalling $554,000 taken at SNBNM during the period of June 8, 1978 to December 21, 1978.

RECOMMENDATIONS

We recommend that SBA take immediate action to recover all funds loaned to this licensee and that the firm be removed from the Investment Program. Any action taken should be coordinated with the United States Attorney in Minneapolis.

BACKGROUND OF LICENSEE

Sagera Venture Corporation, Inc. was chartered under the laws of the State of Delaware on June 1, 1977. It was organized and chartered solely for the purpose of performing the functions and conducting the activities anticipated under the Small Business Investment Act of 1958, as amended.

On June 8, 1977, Sagera Venture applied for a Small Business Investment License under Section 301(d) of the Small Business Investment Act. The application was initially approved on September 28, 1977, based in part on the representation that $500,000 in initial private paid in capital was on deposit subject to no encumbrances in a St. Paul, Minneapolis bank. On October 7, 1977, the Agency considered Sagera's application to be withdrawn with prejudice to any future filing when it was learned the applicant did not have on deposit the $500,000 as had been represented.

On February 27, 1978, as part of a resubmission request a new bank letter was submitted indicating the applicant had the principal sum of $500,000 in an operating account in a North Miami, Florida bank, being held by that bank without any encumbrances. The matter of insufficient funds was clarified on March 28, 1978, and SBA re-approved the application on April 5, 1978. Sagera Venture was issued License No. 05/05-5121 dated April 5, 1978.

On March 30, 1978, Sagera Venture applied for funding from SBA in the amount of $500,000. On May 2, 1978, the application was approved and SBA purchased 500 shares of the licensee's $1,000 par value preferred stock. A U.S. Treasury Check, No. 56749050 in the amount of $500,000 was issued to Sagera Venture Corp., Inc. on May 4, 1978, as payment for the stock. The stock was issued pursuant to Section 303(c) of the Small Business Investment Act.

On December 6, 1978, Sagera Venture applied for additional funding from SBA in the amount of $500,000. The application was approved on February 12, 1979, based in part on submitted financial data as of December 31, 1978, and corrective actions reportedly taken on findings disclosed during an Agency examination of the licensee's records for the period ending September 30, 1978. U.S. Treasury Check No. 14128669 in the amount of $500,000 was issued to the licensee on February 15, 1979. The debt was secured by a 10 year subordinated debenture bearing an interest rate of 6-1/4% from date of issue to June 12 1984, and an interest rate of 9-1/4% thereafter until all principal and interest is paid.

Sagera Venture began its lending activities in June 1978, with no private paid in capital and with borrowed funds secured solely with a Certificate of Deposit in the amount of $470,000 which had been purchased with the initial funding obtained from SBA on May 5, 1978. In financial reports submitted to the Agency, 14 financings were reportedly made through June 30, 1979. They are as follows:

CHA Good Sports Co., Inc.	$ 50,000
Seville Leasing	150,000
M.C. Investments	150,000
Gale Bonaventure Associates	150,000
Robert Lloyd Associates	126,000
Flynn, Inc.	150,000
Executive Airways	150,000
MARA, Inc.	45,000
North Florida Yachts	150,000
Fair Automotive	150,000
Alyce Corp.	20,000
Goldbrick International	150,000
Michigan Burgers	140,000
Bill's Trucking	50,000
Total	$1,631,000

Sagera Venture has authority to issue 1,000 shares of common stock with a par value of $500 each. The sole owner of this class of stock is Gerald A. Stone.

It also has authority to issue 500 shares of preferred stock with a par value of $1,000 per share. This class of stock was designated to be issued only for sale to SBA and was purchased by the Agency on May 2, 1978.

Sagera Venture's officers and directors are as follows:

Gerald A. Stone - President/Director
Thomas P. Gray - Vice President/Director
Stephanie Stone - Secretary/Treasurer/Director
Richard Peterson - Director
Richard B. Heise - Director

In addition to Sagera Venture, Gerald Stone is associated with Woodhill SoDak Corp., Air, Land and Sea Travel, and the Keystone Corporation, all operated from the same business address as Sagera Venture, 2850 Metro Drive, Suite 506, Bloomington, Minnesota.

Gerald Stone is also a registered applicant's representative at the SBA's Minneapolis District Office where he assisted in the preparation of at least two 7(a) participation loans which were authorized in the amounts of $100,000 on November 7, 1979, and $170,000 on December 5, 1979. The participating bank on both loans was the Bank of Minneapolis and Trust Company where Mr. Stone had opened accounts with SBA leverage funds. He also reportedly assisted one of the portfolio concerns, a sporting goods distributor, to obtain a $650,000 loan from the Farmers Home Loan Administration.

On April 5, 1979, Sagera Venture applied for additional funding of $500,000 offering a second tier of preferred stock as leverage. The application was retained by the Agency pending the finalization of proposed SBA regulations implementing provisions of Public Law 95-507 that affected the small business investment program.

On September 26, 1979, an updated financial report and certification and eligibility for second tier funding was submitted. Gerald Stone was informed no action would be taken (by SBA) before the examination scheduled for October 1979 was completed.

In a letter dated November 2, 1979, Gerald Stone informed SBA that the Board of Directors of the licensee had unanimously decided to cease operating as a 301(d) company.

FINDINGS

Possible Conspiracy to Defraud SBA - Title 18 U.S.C. Sections 371 and 2

Possible False Statements - Title 18 U.S.C. Sections 1001 and 1006 and Title 15 U.S.C. Section 645(a)

Possible Mail Fraud Title 18 U.S.C. Section 1341

Possible Wire Fraud Title 18 U.S.C. Section 1343

False Filings Made to SBA - Section 107.1008 and SBA Policy and Procedural Release # 2016

Gerald A. Stone, President of Sagera Venture Corporation, Inc. (Sagera), may have conspired with John U. Rykert, Senior Vice President of the Second National Bank of North Miami (SNBNM), Antonio A. Sobral, Jr., Leonard J. Lansburgh and others to defraud SBA by means of obtaining a license for Sagera to operate as a Section 301(d) Small Business Investment Company (MESBIC) and by inducing the Agency to advance $500,000 as initial leverage funding to the licensee. In furtherance of the above, the services of the U.S. Postal System as well as those of a telephone were employed in submitting possible false statements to the Agency in order to influence it to issue a license to Sagera on April 5, 1978, and to advance $500,000 to it on May 4, 1978. The investigation disclosed that Gerald A. Stone had not invested any funds in the applicant licensee and that Sagera had no funds or activity in any account at SNBNM prior to receipt of funds from SBA on May 5, 1978, all of which was contrary to the numerous representations and verifications made by Mr. Stone and others to SBA. As a result, Sagera obtained a license to operate as a Section 301(d) MESBIC without the private capitalization investment as required by the Small Business Investment Act of 1958, as amended, and it began its lending operations in June 1978 with borrowed funds derived and secured by an equity capital base funded solely by SBA, thereby denying that Agency of its lawful right to a proper administering of the Small Business Act as mandated to it and intended by Title 15 United States Code Section 661, et seq.

Title 18 U.S.C. Section 371 states that if two or more people conspire to commit any offense against the United States, defraud the United States or any Agency thereof in any manner or for any purpose and one or more such persons do any act to effect the object of the conspirary they may be fined or imprisoned or both. Title 18 U.S.C. Section 2 states that whoever commits an offense against the United States, or aids, abets, conceals, commands, induces, or procures its commission, is punishable as a principal and whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

Title 18 U.S.C. Section 1001 states that whoever, in any matter within the jurisdiction of any Department or Agency of the United States, knowingly and willfully, falsifies, conceals, or covers up by any trick, scheme, or device, a material fact or makes any false, fictitious or fraudulent statement or presentation or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, may be fined, imprisoned, or both.

Title 18 U.S.C. Section 1006 states that whoever, being an officer, agent or employee of or connected in any capacity with . . . any small business investment company, with intent to defraud any such institution . . . or any individual, or to deceive any officer, auditor, examiner or agent of any such institution or of department or agency of the United States, makes any false entry in any book, report or statement of or to any such institution . . . with intent to defraud the United States or any agency thereof . . . shall be fined or imprisoned or both.

Title 15 U.S.C. Section 645(a) states that whoever makes any statement knowing it to be false for the purpose of influencing in any way the action of the Small Business Administration, or for the purpose of obtaining anything of value under this Act, shall be subject to a fine or imprisonment or both.

Title 18 U.S.C. Section 1341 states that whoever having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, and for the purpose of executing such scheme or artifice or attempting so to do places in any Post Office or authorized depository for mail, any matter or thing whatsoever to be sent or delivered by the Post Office

Department, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the directions thereon or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined or imprisoned or both.

Title 18 U.S.C. Section 1343 states that whoever . . . for obtaining money or property by means of false or fraudulent pretense, representations . . . transmits or causes to be transmitted by means of wire . . . communication in interstate or foreign commerce any writings . . . or sounds for the purpose of executing such scheme or artifice shall be fined or imprisoned or both.

Section 107.1008(b) states that any false statement knowingly made, or misrepresentation or failure to state a material fact necessary in order to make a statement not misleading in the light of the circumstances under which the statement was made, in any document submitted to SBA shall constitute a violation of these regulations.

SBA Policy and Procedural Release # 2016 states as a general standard, applicants to become a Section 301(d) licensee shall be able to evidence initial private capital of at least $500,000 in order to receive a license.

The initial license application for Sagera Venture Corporation, Inc. (Sagera), dated June 8, 1977, was submitted and received by SBA on July 9, 1977, through the U.S. Postal

System. By attachment to the application it was stated that $500,000 of private funds reported in the capitalization section would be placed on account through an unencumbered bank verification letter which would become executed as per the conditions of an attached bank letter. The attached letter, dated May 16, 1977, was from John U. Rykert, Senior Vice President of the Second National Bank of North Miami (SNBNM). It stated in part the following:

> "We have the sum of $500,000 available to Sagera Venture Corporation, Inc. We understand that Sagera has applied for a license as a Section 301(d) SBIC.
>
> "Our instructions are to deposit said sum of $500,000 directly into the account of Sagera Venture Corporation, Inc. upon the completion by SBA of the following acts:
>
> 1. Issue a comment letter on the application, and
> 2. Publish notice of the application filing in the Federal Register.
>
> "Upon completion of the above stated events, such sum of $500,000 shall be deposited directly in the Account of Sagera, at which time the funds will be held without encumbrance or restriction."

The notice of application was published in the Federal Register on July 21, 1977, and published in the local newspaper on July 29, 1977.

Although Sagera's location is Hennepin County, its application stated the licensee would conduct its operation on a national basis and in other areas within the United States of America and its territories and possessions. Hennepin County encompasses Bloomington, Minnesota.

In a letter dated September 21, 1977, sent through the U.S. Postal System and received by SBA's Investment Division in Washington, D. C. on September 28, 1977, James Gahlon, Assistant Cashier at Western State Bank of St. Paul (Minnesota), advised that Sagera had on the letter's date, opened an account at that bank and had on deposit in the account the sum of $500,000. In a memo attached to the letter Gahlon informed that Western State Bank had placed a hold on the $500,000 deposit of Sagera, that the uncollected funds were being held and would not be released until notice was received from the drawee bank.

In a licensing action dated September 28, 1977, Sagera's application to operate as a Section 301(d) MESBIC was approved by the SBA.

As reported above, the correspondence from the Western State Bank was also received by SBA on September 28, 1977. It was learned that the drawee bank on which the $500,000 check was drawn was returning it to the Western State Bank because of non-sufficient funds. As a result the Agency informed Sagera that its application for license was considered withdrawn by SBA with prejudice to any future filing.

The investigation disclosed the $500,000 check which Mr. Stone had represented as his initial capital investment in Sagera was Check No. 1056 drawn on Woodhill Corporation Account No. 307 924 8 at the Second National Bank of North Miami, located in North Miami, Florida. The check, dated September 21, 1977, is made payable to the Western State Bank and is signed by

Gerald Alan Stone. In addition to Sagera Venture, Mr. Stone is President of Woodhill Corporation. A review of Woodhill Corporation's bank statements for the period of August 31, 1977 to October 31, 1977, showed Woodhill's account balance never exceeded $136.25.

In a letter dated March 6, 1978, addressed to SBA, Antonio A. Sobral, Jr., Executive Vice President of Interamerican Marketing Association, submitted correspondence intended to update SBA with regard to the status of Sagera's license application.

It is noted that prior to the initial application submission, by letter dated April 21, 1977, Mr. Stone had informed SBA that he had conveyed to Mr. Sobral power of attorney to represent his (Stone's) interest with respect to the license application. Stone had designated Mr. Sobral to act as agent and attorney-in-fact for Sagera Venture Corporation.

Correspondence submitted by Mr. Sobral on behalf of Mr. Stone included a letter dated February 27, 1978, to SBA in which Mr. Stone reportedly wrote the following explanation for the Woodhill Corporation check which had been returned for non-sufficient funds, and in which reference was being made to a new bank letter verifying that Sagera had $500,000 on deposit to its credit:

"Sagera Venture Corporation made application for a 301(d) SBIC license on June 8, 1977. Pursuant to such application, a loan of $500,000 was secured from a Miami bank from which such loan proceeds were deposited in the Western State Bank of St. Paul, as evidenced by the bank's letter of September 21, 1977 sent to SBA. Such letter represented that such funds were on deposit with no encumbrances. It would not appear unusual that a hold would be temporarily placed on this account until the check cleared the Miami bank.

"However, during such bank correspondence to SBA in September and after representations made in good-faith to SBA, pursuant to timely applications on June 8, 1977, I sold certain assets which temporarily reduced my net worth. My banker in Miami felt that such sale of assets created a technical insufficiency to fully collateralize a loan of $500,000 and for that reason, the previously approved loan was called prior to disbursement but subsequent to my corresponding deposit in the Western State Bank of St. Paul. Likewise, the Western State Bank issued the letter to SBA in good-faith prior to such action by the Miami bank.

"With such a large sum involved, and my continued efforts to gain approval of 301(d) SBIC license, it would certainly not be my intention, or any agent(s), to make any improper or incorrect representations.

"Please find enclosed, a new bank letter which verifies that $500,000 is on deposit to the credit of Sagera Venture Corporation. I am presently ready, willing and able to begin operations as a 301(d) SBIC. I trust that such explanation is satisfactory. If your office is in need of any additional information, please consult with my attorney-in-fact, Mr. Tony Sobral, or my office directly."

The letter was signed Gerald Alan Stone. On February 15, 1980, Mr. Stone acknowledged his signature on the letter, however, he stated he had not written it and he had not secured the $500,000 loan from the Miami Bank, as reported above. In addition, he said he did not have the $500,000 on deposit which was referred to in the new bank letter, but that it had been his intention to borrow it. Mr. Stone identified Antonio A. Sobral, Jr. as the author of the above letter.

A review of Woodhill Corporation's loan/credit file at the Second National Bank of North Miami on March 21, 1980, where its account was maintained, showed no evidence that Woodhill Corporation or Mr. Stone had applied for or received a $500,000 loan from the bank, confirming Mr. Stone's statement of February 15, 1980.

The new bank letter referred to by Mr. Sobral in his letter of March 6, 1978, was dated February 27, 1978, and was signed by John U. Rykert, Senior Vice President of the Second National Bank of North Miami. It was addressed to SBA and advised that Sagera's bank Account No. 308 646 4 had been established at the bank as of February 27, 1978, and that there were funds of $500,000 in that account as of that day which were unencumbered.

The new bank letter was discussed at a meeting held on March 28, 1978, at which Messrs. Stone and Sobral discussed SBA's reconsideration of Sagera's license application with SBA Investment Division officials. The meeting's conclusion was that the matter of insufficient funds had been clarified and the Agency's license action was updated to reflect the approval of Sagera's application.

A notation on Mr. Rykert's bank letter indicated it had been verified on April 4, 1978 by H.T.M. On February 25, 1980, A financial analyst in SBA's office of 301(d) Operating stated the initials were his and that he had made the notation. He stated his verification consisted of a telephone check from his office in Washington., D.C. to John Rykert in Miami, Florida, in which Mr. Rykert represented and confirmed Sagera had $500,000 in its operating account.

Based on the above representations, SBA was influenced in a reconsideration of Sagera's license application and a license to operate as a Section 301(d) MESBIC was approved on April 5, 1978.

The investigation disclosed Gerald A. Stone had not invested any funds in the applicant licensee and that Sagera Venture had no funds or activity in any account at SNBNM prior to May 8, 1878. A subpoena request for bank statements for Sagera's operating Account No. 308 646 4 at the Second National Bank of North Miami was served on John U. Rykert on February 4, 1980. The request specified bank statements for Sagera's account from its opening date through September 1978. The request was made in an effort to verify the representations made by Mr. Stone and the bank regarding the amount in Sagera's operating account during the time period of SBA's reconsideration of the license application. Records made available by the bank on February 20, 1980 showed the account opened with a $.0 balance on May 4, 1978 and had no activity in it until May 8, 1978, the date when SBA's initial leverage funds of $500,000 were deposited into it, along with a $500,000 transfer from the personal account of Leonard J. Lansburgh.

Norma E. Crow, Secretary to John U. Rykert, stated on February 20 and 22, 1980, that her confirmation with the bank's Central Records Department indicated the May 1978 statement represented all the initial opening activity in Sagera's account. By telephone on May 30, 1980, Ms. Crow reiterated her earlier comments that the bank's Central Records Department had no record of any account activity for Sagera prior to the May 1978 statement and for that reason there were no prior bank statements.

John Rykert was unable to explain the above in connection with his letter of February 27, 1978 stating that Sagera had funds of $500,000 on deposit in the account. When asked, he said he recalled someone from SBA contacting him by telephone in April 1978 to confirm Sagera's account and the amount in it, however, he was unable to produce any records or other evidence during the investigation which would support the basis for his letter of February 27 and his confirmation of April 4, 1978.

As reported above, Mr. Stone stated he did not have the $500,000 but that it had been his intention to borrow it. The investigation disclosed Sagera did borrow $500,000 indirectly from SNBNM through Leonard J. Lansburgh for an eight-day period in May 1978 in connection with its application for initial leverage funding from SBA, however, this loan transaction and its repayment which was concealed from the Agency was after the

April 5, 1978, approval date for the issuance of Sagera's license.

Sagera's application for initial funding of $500,000 dated March 30, 1978, was transmitted through the U.S. Postal System and received by SBA's Investment Division on April 10, 1978. This application for initial funding was made pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended, and was submitted by means of an SBA Form 1022A. In return for the leverage funding requested of SBA, Sagera was offering 500 shares of its preferred stock with a set value of $1,000 per share. Support for the application included a financial report showing Sagera's cash and capital positions as $500,000 each as of March 30, 1978. Further support was referred to in a cover letter dated April 19, 1978, which was also transmitted through the U.S. Postal System and received by the Agency on April 20, 1978. The cover letter was from Antonio A. Sobral, Jr. and was in response to an SBA letter of April 12, 1978, sent to Sagera Venture at its business address in Edina, Minnesota. SBA had requested additional information of Sagera so that the funding application could be processed further. A request was made to have Sagera authorize its bank to complete and return to the Agency an SBA Form 860, a confirmation letter regarding Sagera's account balance at its bank of account, i.e., SNBNM.

Sobral's cover letter had as one of its enclosures a confirmation letter signed by John U. Rykert of SNBNM. It confirmed Sagera had $500,000 in its operating Account No. 308 646 4 at that bank as of April 14, 1978.

Relying on the above, submitted to influence SBA, the Agency on May 2, 1978, approved the purchase of 500 shares of Sagera's preferred stock with a par value of $1,000 per share for a total amount of $500,000.

By letter of March 30, 1978, Mr. Stone informed SBA that he had designated and appointed Jerry B. Baker to serve as an agent and/or attorney-in-fact for the sole purpose of receiving the $500,000 from SBA for the sale of Sagera's preferred stock to the Agency.

A receipt signed Jerry B. Baker indicates he picked up U.S. Treasury Check No. 56,749,050 in the amount of $500,000 on May 5, 1978. The check was dated May 4, 1978, and was payable to the order of Sagera Venture Corp. Inc. In return, SBA was issued Certificate No. 1 dated May 2, 1978, indicating it was the owner of 500 - 3% cumulative and preferred shares of Sagera Venture stock with a fully paid and non-assessable par value of $1,000 per share.

As reported above, the investigation disclosed Sagera had no funds or any activity in any account at SNBNM prior to May 8, 1978. John U. Rykert could produce no evidence to support his confirmation letter of April 17, 1978, that Sagera had $500,000 in its account at SNBNM.

A subpoena was served on Gerald A. Stone, President of Sagera Venture, on January 25, 1980, requiring him to produce all corporate and financial records of Sagera Venture Corporation. A review of these records during a five-day period beginning February 11, 1980,disclosed no evidence to support the representations made by Mr. Stone and others that a private capital investment of $500,000 had been made in the licensee.

The investigation disclosed the initial deposit to Sagera's operating Account No. 308 646 4 at SNBNM was made on May 8, 1978, in the amount of $1 million. Records made available by SNBNM indicate the $1 million deposit consisted of the $500,000 Treasury Check from SBA and a $500,000 transfer from Account No. 226 292 7. The deposit was in the form of a credit memo entry to the account. Prior to this the account balance was $.00.

On the same date a debit memo entry was made to the account withdrawing $1 million from it. These funds were used to purchase a non-negotiable time certificate of deposit (C/D) at SNBNM. The C/D was No. 06899 dated May 8, 1978, payable to Sagera Venture Corporation in the amount of $1 million.

Bank records revealed the C/D was presented for payment on May 16, 1978, and was distributed as follows:

Credit Memo Entry to Account No. 308 646 4	$ 5,000
SNBNM Official Check No. 27228	525,000
SNBNM C/D No. 06918	470,000
Total	$1,000,000

Sagera's checking account and bank statement reflect a $5,000 credit memo entry made to the account on May 16, 1978. There were no other deposits to Sagera's account until June 8, 1978.

SNBNM official Check No. 27228 dated May 16, 1978, is payable to Leonard Lansburgh. Its reverse directs that it is for deposit only to the account of Leonard Lansburgh, Account No. 226 292 7. This account was the source of the $500,000 transfer to Sagera on May 8, 1978. On February 21, 1980 Lansburgh confirmed he had received a check for $525,000. He stated that Account No. 226 292 7 was his personal account at SNBNM and that it was the source of the $500,000 credit transfer to Sagera's account on May 8, 1978. He stated he loaned the money to Sagera in order to enable it to comply with an SBA regulation which required that Sagera show initial capitalization of $500,000 before it (Sagera) could receive leverage funding from SBA.

When asked the source of the funds he loaned to Sagera, Lansburgh stated he had borrowed the money from SNBNM on May 8, 1978, the same date he loaned the money to Sagera. Checking account records made available by Lansburgh showed the credit memo entry for his loan from SNBNM as well as the debit memo transfer to Sagera's account as having occurred on May 8, 1978. The credit and debit memo entries sent by the bank to Lansburgh to document these transactions indicate they were made per the instructions of John U. Rykert (J.U.R.), Senior Vice President at the bank.

Lansburgh's records also reflect the deposit of the $525,000 bank check on May 16, 1978. On the same date a debit memo withdrawal was made repaying the loan Lansburgh had taken eight days earlier from the bank. The credit and debit memo entries indicate the loan to Lansburgh was via SNBNM, Note No. 9568. The $25,000 difference between the amount loaned to Sagera and the amount repaid was for a concealed representative fee reported on in a subsequent finding.

When asked why he was utilized as a "go between" between the bank and Sagera as opposed to the bank dealing directly with Sagera, Lansburgh stated Gerry Stone did not have sufficient credit standing to carry a loan like this on his own.

On March 17, 1980, Mr. Lansburgh was advised that a review of the bank's loan/credit file would have to be made in order to confirm information provided earlier by him regarding the above, which involved a loan from SNBNM, the proceeds of which were credited to his personal account at that bank. After consulting with his attorney, Lansburgh declined to give his written permission for the review.

The certificate of deposit purchased in the name of Sagera Venture Corporation was subsequently renewed on a periodic basis and was used by Sagera to collateralize a series of 10 loans which it took from SNBNM for lending activity with small business concerns beginning in June 1978.

As detailed above, the investigation disclosed that contrary to the representations and verifications made by Mr. Stone and others to SBA, Sagera was issued a license to operate as a Section 301(d) MESBIC on April 5, 1978, without the private capitalization investment as required by the applicable laws and regulations, and it began its lending activities in June 1978 with borrowed funds derived and secured by an equity capital base funded solely by SBA in violation of Title 15 United States Code Section 682(a).

Possible Conspiracy to Defraud SBA - Title 18 U.S.C. Sections 371 and 2

Possible False Statements - Title 18 U.S.C. Sections 1001 and 1006 and Title 15 U.S.C. Section 645(a)

Possible Mail Fraud Title 18 U.S.C. Section 1341

Possible Wire Fraud Title 18 U.S.C. Section 1343

False Filings Made to SBA - Section 107.1008

Gerald A. Stone and John U. Rykert may have conspired with Thomas P. Gray, Kent R. Ellison and Mel Sorem to defraud and deceive SBA by making material false statements and entries in books and reports that were submitted to the Agency. The investigation disclosed that during SBA's initial examination of Sagera's books and records in October 1978, but unknown and unreported to the Agency, Sagera Venture became the beneficial recipient of three 31-day personal loans totaling $525,000 taken by Messrs. Gray, Ellison and Sorem from SNBNM. The proceeds were used to purchase a certificate of deposit at that bank in the name of Sagera Venture Corp. for a 31-day period which was then represented by Mr. Rykert as being a security investment of Sagera at the bank, thereby concealing and deceiving SBA with respect to the shortage of cash and equity capital which had been created by an undisclosed payment of $525,000 to Leonard Lansburgh on May 16, 1978.

An SBA Form 860 dated October 27, 1978, and signed John U. Rykert, Senior Vice President, Second National Bank of North Miami, was submitted to SBA confirming Sagera Venture had on hand the following time certificates of deposit invested as idle funds at that bank as of September 30, 1978:

Certificate No.	Amount	Interest Rate
7158	$470,000	7-1/2%
7267	525,000	7 %
Total	$995,000	

The financial reports for the interim period ending November 30, 1978, and the annual report for the fiscal year ending December 31, 1978, include a schedule reporting Sagera's idle fund balance as $995,000 during the period of May 1978 through November 1978. The financial reports were certified by Gerald Alan Stone as Sagera's Chief Financial Officer and verified by Stephanie Stone, Secretary, and were submitted in support of Sagera's application for additional funding of $500,000 in an Application for Funds that was dated December 6, 1978.

SBA's first examination of the licensee's books and records covered the period from the date of licensing April 5, 1978, through September 30, 1978. The on-site completion date of the audit was October 25, 1978. Balance sheet records made available at that time reported an asset account titled "Invested Idle Funds" with a balance of $995,000 as of September 30, 1978.

Records made available by Gerald A. Stone on February 11, 1980, pursuant to a subpoena demand of January 25, 1980, for all Sagera's corporate and financial records, did not include general ledger, journal, or accounting records for the period ending December 31, 1978. Mr. Stone stated these records could not be located. As a result, the accounting basis for the amount shown as invested idle funds on the various balance sheet reports could not be substantiated. In addition, there were no records or other data to show the offsetting accounting entries which would explain the eight-day loan/transfer of $500,000 from Leonard Lansburgh on May 8, 1978, and the repayment of $525,000 on May 16, 1978. No evidence could be found that this transaction had been reported or made known to the Agency.

The investigation disclosed Certificate No. 7267 was voided and became Certificate No. 7268, which was purchased in the name of Sagera Venture Corp. for a term of 31 days in the amount of $525,000 on October 24, 1978. The bank's credit file for the certificate indicates the source of funds for this certificate's purchase was from loan proceeds and Sagera's operating Account No. 308 646 4 was identified. Bank records show the certificate was redeemed on November 24, 1978, and used to purchase official Check No. 28907 in the amount of $525,000 payable to the order of Sagera Venture Corp. The reverse of this check shows it was presented for payment at SNBNM on November 24, 1978 and it indicates it was credited to the payee's Account No. 308 646 4 at that bank.

A review of Sagera's bank statement for the period ending November 30, 1978,showed the check had not been credited to the account as was indicated on the check's reverse. A review of Sagera's bank statement for October 1978 as well as its loan/credit file at SNBNM showed no evidence of where the $525,000 had originated prior to the purchase of the certificate nor could it be determined what its disposition was after its redemption and after the check payable to Sagera Venture Corp. was presented for payment on November 24, 1978.

On February 21, 22 and on March 20, 1980, John U. Rykert claimed he did not know there the funds originated or where they had gone. He said he had no knowledge of the funds and he could not explain why the cashing in of the bank check did not reflect in Sagera's checking account statement at SNBNM as it should have, based on the endorsement on its reverse.

A collateral receipt document of SNBNM dated November 15, 1978, was located at the bank on March 18, 1980. The receipt indicated a Certificate of Deposit No. 07268 in the name of Sagera Venture Corporation for $525,000 had been deposited into the bank's vault by the Commercial Loan Department and was released and received by John Rykert on November 24, 1978. As a Senior Vice President, Mr. Rykert heads the bank's Commercial Loan Department. A notation on the receipt shows the proceeds from the certificate were used to pay off C/L No. 10025, 10024 and 10023 on November 24, 1978. This was the date the bank check referred to above, payable to Sagera Venture Corp., had been presented for payment.

On March 24, 1980 Mr. Rykert informed that $525,000 proceeds from the bank check (to Sagera) were applied against three loans taken out by three individuals from Minneapolis, Minnesota. The individuals, addresses and the loan amounts according to Mr. Rykert were as follows:

Thomas Gray 2540 24th Ave. South Minneapolis, Minn.	$200,000
Mel Sorem 2850 Metro Drive Bloomington, Minn.	200,000
Kent Ellison 9707 Mill Creek Drive Eden Prairie, Minn.	125,000
Total	$525,000

Mr. Rykert was unable to state which loan number applied to which individual. The investigation revealed the address given for Mr. Gray is the business location of Ellison Meat Company of which Kent Ellison is the President. The address given for Mr. Sorem is the licensee's address and the address given for Mr. Ellison was the home address for Gerald A. Stone that was submitted with Sagera's application for license.

Rykert stated the above were personal loans in the names of those individuals and that he knew Mr. Stone and/or Sagera was to be the beneficial recipient of the loan proceeds. He stated these individuals were personal friends of Mr. Stone. Regarding the nature of the loans to three individuals for the actual benefit of a third party, in this case Sagera Venture, Rykert stated it was a common banking practice. He stated if Sagera had not repaid the loans or if it had gone bad, then the bank would have sued the three individuals. When asked if the three individuals actually came down to the bank to submit formal application papers and to sign the Notes for the loans, Mr. Rykert stated he was not sure if they had actually come to the bank for it. The bank is located in North Miami, Florida. He stated it was entirely possible the transactions could have been executed through the mails. Rykert also stated that the Notes when paid were undoubtedly mailed back to the borrowers' given addresses in Minnesota.

Kent Ellison stated he had taken out a loan of $125,000 from SNBNM in October 1978. He said the loan was actually for the benefit of Gerald Stone and Sagera Venture and that he received none of its proceeds. Ellison stated the loan was a personal loan which was unsecured. He said he signed a Note for it in Minneapolis and that he did not go down to Florida to submit any application papers or to sign any paperwork in connection with it. Ellison stated the mails were used because he did not want to put out $400 in air transport costs to Florida and return for the transaction. Mr. Ellison lives in Minnetonka, Minnesota, and is the President of Ellison Meat Company located in Minneapolis. Mr. Ellison said the loan was repaid and that since it was an unsecured loan, he would have been liable in the event Sagera failed to pay. When asked the purpose of the loan, Ellison stated Stone reportedly was at his legal borrowing limit at the bank and needed the funds for 30 to 60 days.

Ellison said he undoubtedly spoke to John Rykert of the bank over the telephone in regard to the loan. He also said he did not know where the paid Note was and that he would not give his written consent permitting an examination of the bank's credit file on it.

On April 18, 1980, Gerald Stone stated he would not discuss the purpose in having his friends from the Minneapolis area take out personal loans from Sagera's bank of account in Florida for and on behalf of Sagera Venture unless his

Sagera's license application papers identify Mr. Gray as its Vice President and a Director. On April 23, 1980, Gray informed he had resigned these positions as of January 10, 1980.

Mel Sorem stated he had signed a Note for a personal loan from the SNBNM in October 1978. He said he had taken the loan on behalf and for the benefit of Gerald Stone and Sagera Venture, whom he referred to as a boyhood friend. Mr. Sorem lives and works in Edina, Minnesota. He stated he did not go to Miami, Florida, for the loan application and Note signing and that Gerald Stone had brought the Note to him at his office in Edina for signing. Sorem stated he did not remember submitting any application papers for the loan at all. He said he never heard anything more about it except that it had been paid. He also said he never saw his copy of the paid Note and that he had no documentation on the loan. When asked its amount, he said it could have been for $200,000, however, he could not be sure and that, in any event, he had received none of its proceeds. When asked the purpose of the loan, according to Sorem, Stone reportedly said he needed it for 30, 60 or for 90 days to finance a housing deal for Indians somewhere in North or South Dakota. On April 18, 1980, Mr. Sorem gave his written consent for a review of the bank's loan file on this loan.

leverage funding. It had not been reported or disclosed that Leonard Lansburgh had received $25,000 as repayment for a fee he had advanced to the Interamerican Marketing Association of which Mr. Sobral was the Executive Vice President, on behalf of Sagera Venture. The investigation disclosed the $25,000 repayment was made from the leverage funding that had been advanced by SBA to the licensee on May 5, 1978.

Sagera's license application submitted to SBA on July 9, 1977, through the U.S. Postal System included the following explanation regarding the names of persons assisting in the preparation of the application:

> "Antonio A. Sobral, Jr.
> Executive Vice President
> Interamerican Marketing Association
> 2341 Jefferson Davis Hwy, Suite 736
> Arlington, VA 22202
> (703) 920-8563 Telex 82-4425
>
> "Mr. Sobral assisted SAGERA Venture Corporation Inc., in the formation of the corporation and process of the license application. No compensation was paid in that the services were provided to Mr. Gerald Stone from his affiliation with the Interamerican Marketing Association, a non-profit corporation, as an Associate Corporate Member, incorporation, filing and application fees were paid by The Woodhill Corporation."

Sagera's request for initial funding dated March 30, 1978, was by means of an SBA Form 1022A, Application for Funds, which was received by SBA on April 10, 1978, through the mails. In support of the application and also submitted through the mails and received by the Agency's Investment Division or April 20, 1978, was a cover letter dated April 19, 1978, from Mr. Sobral which included as one of four enclosed items a Compensation Agreement signed by Gerald A. Stone and Antonio A. Sobral, Jr., as attorney-in-fact. The Compensation Agreement, SBA Form 159, indicates no compensation was paid or was to be paid in connection with the application and loan from SBA. The agreement is dated March 30, 1978, the same date as that on the SBA Form 1022A, Application for Funds.

Sagera's application was approved on May 2, 1978, and $500,000 was disbursed on May 5, 1978 and deposited into Sagera's account at SNBNM on May 8, 1978, along with a $500,000 loan transfer from Leonard J. Lansburgh.

The investigation disclosed that although Mr. Lansburgh loaned Sagera $500,000 on May 8, 1978, Sagera repaid Lansburgh $525,000 eight days later on May 16, 1978. Sagera's account shows no other deposit activity in the account for this period other than the deposit from SBA and Mr. Lansburgh.

When asked why he was repaid $25,000 more than he loaned Sagera during the loan transaction, Lansburgh stated it was to reimburse him for a $25,000 payment he had made to Interamerican Marketing Association. He said Interamerican had put the SBIC together and that this was its fee ($25,000). He said he had advanced the money to Interamerican on behalf of Sagera Venture.

In support of this, Mr. Lansburgh made available Check No. 458 drawn on his personal Account No. 226 292 7 at SNBNM for $25,000, paid to the order of Interamerican

Marketing Association. The check is dated April 10, 1978, the same date that SBA received the application for funding, through the mails from Sagera Venture. The reverse of this check indicates it was credited to the payee's account at the main office of Riggs National Bank in Washington, D.C.

Mr. Stone confirmed that Leonard Lansburgh had advanced $25,000 to Mr. Sobral on Sagera's behalf and that Sagera repaid Lansburgh $25,000 after the funding from SBA was received in May 1978. Stone stated he did not want to pay so much to Sobral for his services, however, it was a cost for getting into the program.

Antonio J. Sobral, Jr. was not contacted during this investigation. However, his activities as well as the activities of other officials of the Interamerican Marketing Association are presently being investigated by the Department of Justice in connection with the formation and funding of other SBIC's.

As a result, an apparent compensation fee was paid in connection with the license application and initial funding of Sagera Venture which was contrary to the representations that were made by Mr. Stone and Sagera's agent, Antonio A. Sobral, Jr.

Possible Conspiracy to Defraud SBA -
Title 18 U.S.C. Sections 371 and 2

Possible Embezzlement of Funds -
Title 18 U.S.C. Section 657 and
Title 15 U.S.C. Section 645(b)

Possible False Statements -
Title 18 U.S.C. Sections 1001, 1002 and
1006 and
Title 15 U.S.C. Section 645(a)

Possible Mail Fraud -
Title 18 U.S.C. Section 1341

Possible Pattern of Racketeering Activity -
Title 18 U.S.C. Section 1961(1)(B) (3) (4) (5)

Possible Prohibited Activities -
Title 18 U.S.C. Section 1962(a), (b) and (d)

False Filings Made to SBA -
Section 107.1008

Gerald A. Stone and Mark Cram may have conspired to deceive and embezzle SBA funds by means of the possession of false papers and by making false misleading statements intended to deceive the Agency with respect to a $150,000 financing represented as having been made to M.C. Investments in July 1978. Mark Cram would not discuss any aspect of the loan or confirm any of the portfolio financing documents maintained by Mr. Stone in the licensee's files which, in part, included promissory installment Notes in the amounts of $140,000 and $10,000 signed Mark Cram. The investigation disclosed the $140,000 had originated with a loan taken by Sagera Venture from the Second National Bank of North Miami that was secured and eventually repaid by the certificates of deposit purchased directly with SBA leverage funds, which had been obtained by Sagera and Mr. Stone by means of a series of possible false statements and verifications submitted to SBA through the U.S. Postal System. Mr. Stone used the $140,000 to open a corporate savings account at the Bank of Minneapolis and Trust Company, and used that account to collateralize and eventually pay off three loans that were used for purposes not reported to SBA. The first loan was for $75,000 and was used as a down payment on Gerald Stone's personal residence in Edina, Minnesota, that was purchased in the name of Stephanie Ann Stone, and which was the location of a telephone through which numerous interstate and foreign telephone calls were placed and then billed to Gerry Stone, in care of Woodhill SoDak Corp., at the same business address as Sagera Venture. Other calls were placed to areas where Sagera Venture had purported lending activities. The second loan was in the amount of $36,000 and was deposited into the Riverside Community State Bank where Mr. Stone maintained a personal checking account. The third loan was for $32,500 which was deposited into a St. Paul bank where Sagera Venture was not a customer. Of the $150,000 total represented as having been loaned to M.C. Investments, the $10,000 balance was apparently deposited into an account controlled by Mark Cram. A financial report, certified by Gerald Alan Stone, that was submitted and received by SBA through the U.S. Postal System on September

26, 1979, described the above financing as an equity interest investment of Sagera. The report was submitted as part of the support of an application to influence SBA to purchase $500,000 of Sagera's preferred stock.

Title 18 U.S.C. Section 657 states whoever being an officer, agent or employee of or connected in any capacity with . . . any small business investment company and . . . embezzles, abstracts . . . or willfully misapplies any monies, funds . . or other things of value belonging to such institution . . . shall be fined or imprisoned or both. . .

Title 18 U.S.C. Section 645(b) states whoever being connected in any capacity with the administration, (1) embezzles, abstracts . . . or willfully misapplies any monies, funds . . . or other things of value . . . (2) with intent to defraud the administration . . . or any individual or to deceive any officer, auditor or examiner of the administration, makes any false entry in any book, report or statement of or to the administration, . . . or (3) with intent to defraud participates or shares in or receives directly or indirectly any money, profit . . . or benefit through any transaction, loan . . . or any other act of the administration . . . shall be punished by a fine or by imprisonment or both.

Title 18 U.S.C. Section 1002 states whoever knowingly and with intent to defraud the United States or any Agency thereof, possesses any false . . . writing or document for the purpose of enabling another to obtain from . . . any Agency . . . any sum of money shall be fined or imprisoned or both.

Title 18 U.S.C. Section 1961(1)(B) defines "racketeering activity" as any act indictable under . . . Title 18 United States Code Section 1341 (relating to mail fraud) and Section 1343 (relating to wire fraud); Subsection (3) defines "person" as including any individual . . . capable of holding a legal or beneficial interest in property; Subsection (4) defines "enterprise" as including any individual . . . associate or other legal entity and any union . . . of individuals associated in fact . . .; Subsection (5) defines "pattern of racketeering activity" as requiring at least two acts of racketeering activity, one of which occurred after the effective date of this chapter and the last of which occurred within ten years . . . after the commission of a prior act of racketeering activity.

Title 18 U.S.C. Section 1962(a) states it shall be unlawful for any person who has received any income derived, directly or indirectly from a pattern of racketeering activity . . . in which such person has participated as a member within the meaning of Section 2, Title 18 United States Code, to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce. Subsection (b) states it shall be unlawful for any person through a pattern of racketeering activity . . . to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in or the activities of which affect interstate or foreign commerce. Subsection (d) states it shall be unlawful for any person to conspire to violate any of the provisions of Subsections (a)(b) . . . of this Section.

The criminal penalties for violations of any provision of Title 18 Section 1962 are contained in Section 1963 as follows:

> "(a) Whoever violates any provision of section 1962 of this chapter shall be fined not more than $25,000 or imprisoned not more than twenty years, or both, and shall forfeit to the United States (1) any interest he has acquired or maintained in violation of section 1962, and (2) any interest in, security of, claim against, or property or contractual right of any kind affording a source of influence over, any enterprise which he has established, operated, controlled, conducted, or participated in the conduct of, in violation of section 1962."

Financial reports for the interim period ending November 30, 1978,and for the annual year ending December 31, 1978, certified by Gerald Alan Stone, were submitted to the Agency in spport of Sagera's application for a second leverage funding of $500,000 that was dated December 6, 1978, and which was approved and disbursed by SBA on February 16, 1979. By letter dated September 24, 1979, addressed to SBA and received by the Agency's Investment Division through the U.S. mails on September 26, 1979, Gerald Stone certified a financial report for the six-month period ending June 30, 1979. The certification had been submitted to update the support of an application for additional leverage funding of $500,000 that was originally applied for via an SBA Form 1022A, Application for Funding, dated March 1, 1979 and signed Gerald Alan Stone, President. Each of the above reports showed a financing to M.C. Investments (M.C.) in the amount of $150,000 as one of Sagera's portfolio securities assets. The financing, described as a loan in the two 1978 reports had been converted by means of an adjusting journal entry to an equity investment of the licensee in the 1979 report.

Portfolio financing documents maintained by Mr. Stone in the licensee's files indicated the financing was made on July 18, 1978, and that $150,000 had been loaned and disbursed on that date. The licensee's files included promissory installment Notes signed Mark Cram of M.C. Investments, which were executed on July 18, 1978 for $140,000 and on July 28, 1978, for $10,000. When Sagera's records were first examined by the Agency, Mr. Cram had represented that the $10,000 was being used for travel expenses in connection with a land site purchase for a franchised restaurant which would account for and required the use of the remaining $140,000. During the investigation, however, Mr. Cram would not discuss any aspect of the loan or confirm any of the documents that had been retained in the licensee's files, including the Notes bearing his signature.

Sagera's records disclosed no evidence to show how the initial $140,000 had been disbursed to M.C. Investments as was indicated by the promissory installment Note dated July 18, 1978, and signed Mark Cram, as well as what was indicated on SBA Form 1031, Portfolio Financing Report, which was one of the licensee's records. Mr. Stone had stated Sagera's accounting records for the period prior to December 31, 1978, could not be located. As a result, it could not be determined or confirmed how the funds were actually transmitted by Sagera to M.C.

Records obtained from the Second National Bank of North Miami (SNBNM) pursuant to a subpoena demand showed the balance in Sagera's operating account never exceeded $18,734.80 during the period of June 30 to July 31, 1978. The investigation did disclose, however, that Sagera Venture Corporation had taken out a loan of $140,000 from SNBNM on July 18, 1978, the same date as the M.C. financing, as evidenced by a loan application and commercial loan agreement signed Gerald A. Stone, President on that date. To secure the loan Mr. Stone assigned to the bank Certificate of Deposit No. 6989 in the amount of $470,000 which had been purchased directly with the SBA leverage funds obtained by Mr. Stone and Sagera on May 8, 1978, by means of a series of possible false statements and verifications that had been submitted to SBA through the U.S. Postal System. The bank records show the loan was liquidated and paid off when the certificate, after a series of renewals, was redeemed on December 15, 1978, and used to purchase official Bank Check No. 29319 dated December 15, 1978, in the amount of $140,000, payable to the Second National Bank of North Miami. The check was then applied against Sagera's loan and the docket file was stamped paid on December 19, 1978. In this manner, Sagera Venture's loan was repaid by SBA funds.

SNBNM records show Sagera's loan was disbursed by means of a Cashier's Check No. 5279 dated July 18, 1978,payable to Sagera Venture Corporation. The check's reverse indicates it was deposited to Sagera's Account No. 000-148 at the Bank of Minneapolis and Trust Company (BOMTC) in Minneapolis, Minnesota. The investigation disclosed the account was a savings passbook account that was apparently opened on or about July 21, 1978, at BOMTC. On February 15, 1980, Mr. Stone stated he had forgotten he had that savings account at BOMTC, he did not remember where the passbook was or if he ever had one, and that in any event the $140,000 was no longer in the account. When asked the disposition of the funds, he stated he could not answer.

Paul Oberstar, Vice President at BOMTC, stated Sagera's Account No. 000-148 had an account balance of $142,500 as of July 21, 1978. The balance consisted of a $140,000 from Sagera's loan at SNBNM and a $2,500 deposit made by a check drawn on Sagera's operating Account No. 308 646 4 at SNBNM dated June 30, 1978, payable to Sagera interest escrow account. The reverse of the latter check indicated it was deposited into Sagera's Account No. 000-148 at BOMTC. Sagera's bank statement shows the check cleared the account at SNBNM on July 24, 1978.

Mr. Oberstar stated the account while still open was not active as he, Oberstar, had made periodic debit withdrawals from it to make payments against various Sagera loans taken at BOMTC. Bank records provided the following information on the Sagera loans:

Check Number	Date	Payee	Amount
80161	July 19, 1979	Gerald A. Stone	$ 75,000
80162	July 19, 1979	Gerald A. Stone	36,000
80220	July 25, 1979	Gerald Stone	32,500
		Total	$143,500

Oberstar stated these were all the loans collateralized and paid for by Sagera Corporation's passbook savings Account No. 000-148.

The reverse of Check No. 80161 shows it was endorsed to the order of Thorpe Bros. Inc. by Gerald A. Stone and deposited into Thorpe Bros. Inc. brokerage trust Account No. 3436-667 at the First Edina National Bank, Edina, Minnesota, on July 21, 1978.

Sharon Barth, who is a Sales Manager, Vice President and a Member of the Million Dollar Club of Thorpe Bros. Inc. Realtors, was shown a photostat of the cashier's check and stated it represented a down payment on a residence that Gerald Stone had purchased in the summer of 1978. She said the house was on Phlox Lane in Edina, Minnesota, and that its total cost was in the $150,000 range.

Sagera Venture Corporation records provided by Mr. Stone on February 11, 1980, included a personal financial statement of Gerald Alan and Stephanie Ann Stone with an address at 4708 Phlox Lane, Edina, Minnesota. The real estate schedule on the statement shows the residence was purchased in 1978 at a cost of $155,000 and titled in the name of Stephanie Stone.* Mrs. Stone is an officer of Sagera Venture Corporation, serving as its Secretary. Property records at the City of Edina Village Hall showed 4708 Phlox Lane was purchased in August 1978 for $142,000 by Stephanie Ann

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* The licensee's application reports her as Secretary/Treasurer, Director.

Stone and that the telephone number at that address was 925-5436. The prior owner's name was listed as John V. Heath. Hennepin County property records record a certificate of title for the property as being in the name of John V. and Marian H. Heath. Mr. Heath was contacted and he confirmed he had sold the house to Stephanie Ann Stone in July 1978. He said Gerald Stone's name did not appear on any of the purchase or closing documents at his request, because Mr. Stone wanted the house to be placed in his wife's name only as he and Mrs. Stone had always handled their real estate transactions. Mr. Heath said a problem developed because Stephanie Stone either did not or could not produce a financial statement and, for that reason, could not obtain a mortgage from a bank. To circumvent this, Heath said he took a second mortgage back for the difference between the sales price and the down payment. He said he had been impressed that the Stones had already put $10,000 down on the property and that Gerald Stone appeared at the settlement with a check for $75,000. Heath said he still has an interest in the property as security for the mortgage he took.

The investigation disclosed the telephone number of the Stone residence had been used to place numerous interstate and foreign telephone calls which were then billed to Gerry Stone, in care of Woodhill SoDak Corp., at the same business address as Sagera Venture. Records made available by SNBNM where Woodhill maintains an account show Gerald Stone is Woodhill's President and Stephanie is its Secretary. Woodhill is involved in the real estate business and shares with Sagera the same published telephone number, 854-2258, as well as the premises at 2850 Metro Drive, Bloomington, Minnesota.

The telephone records provided by Mr. Stone showed several of the interstate telephone calls that were placed through 925-5436 were to areas where Sagera Venture has its purported lending activities.

The telephone records show that on January 13, 1979, a call had been placed to Lombard, Illinois, Area Code 312 620-5269, and another call was placed to the same number on April 4, 1979. On May 22 and 24, 1979, calls were placed to Howard, South Dakota, Area Code 605 772-5551.

The investigation disclosed the Lombard, Illinois number was that of Gayle Wakefield, President of Fair Automotive, which was represented in Sagera's records as having received a financing of $150,000 on January 24, 1979. The Howard, South Dakota number was that of Howard Beef Processors, Inc. which was the business operated by Mr. William Grochow, who was the President of Bill's Trucking, a small business concern which Sagera records represent as having received $50,000 on January 17, 1979. The investigation disclosed no such financings had ever been made to these two small business concerns, as was represented in various reports which had been submitted to the Agency.

Based on the above, it is apparent that Mr. Stone was utilizing his residence by means of the telephone to conduct Sagera Venture's business activities as well as the real estate business of Woodhill.

Cashier's Check No. 80162 payable to Gerald A. Stone in the amount of $36,000 was endorsed Gerald A. Stone and deposited into an account at the Riverside Community State Bank, Minneapolis, Minnesota, on July 21, 1978. Records made available by Mr. Stone showed he maintains a personal Checking Account No. 303 194 5 at that bank, however, the statements for the time period prior to November 1978 could not be located by him during the investigation; therefore, the ultimate use of this check was not determined.

Cashier's Check No. 80220 payable to Gerald Stone in the amount of $32,500 was endorsed Gerald Stone and presented for payment at Gambles Continental State Bank in St. Paul, Minnesota, on July 26, 1978. Carl Stotesbery, the bank's President, stated the bank had no relationship with Sagera Venture Corp, however, there had been some lending activity with Woodhill. The further disposition of the check's use was not determined.

The balance of the $150,000 represented as loaned to M.C. Investments consisted of Sagera Venture Check No. 1015 dated July 28, 1978, in the amount of $10,000 payable to M.C. Investments. The check was drawn on Sagera's operating

Account No. 308 646 4 at SNBNM and cleared that account on August 2, 1978. Although it was endorsed Mark Cram for M.C. Investments, its eventual disposition was not determined owing to Mr. Cram's unwillingness to discuss it.

The financial reports of Sagera submitted by Mr. Stone for the periods ending November 30 and December 31, 1978, depict the M.C. Investments financing as being a loan. By means of an adjusting journal entry in Sagera's general ledger dated January 31, 1979, the loan to M.C. Investments was converted to a 25% equity investment, thereby creating an accounting justification for the non-repayment of the purported $150,000 loan by M.C. as "borrower" to Sagera the "lender."

Possible Conspiracy to Defraud SBA -
Title 18 U.S.C. Sections 371 and 2

Possible False Statements -
Title 18 U.S.C. Sections 1001, 1006 and Title 15 U.S.C. Section 645(a)

Possible Mail Fraud -
Title 18 U.S.C. Section 1341

Possible Pattern of Racketeering Activity -
Title 18 U.S.C. Section 1961(1)(B)(4)(5)

Possible Prohibited Activities -
Title 18 U.S.C. Section 1962(a), (b) and (d)

False Filings Made to SBA -
Section 107 1008

Gerald A. Stone may have conspired with Eugene Vacanti and others to make false and misleading statements and reports to SBA regarding the elimination from Sagera's portfolio of ineligible financings made to CHA Good Sports Company, Inc. ($50,000) and Gale Bonaventure Associates ($150,000). The investigation disclosed the above two financings were not eliminated as was represented by Mr. Stone in correspondence submitted in response to the Agency's comment letter on Sagera's initial audit and in connection with Sagera's application for a second leverage funding of $500,000. In order to conceal the non-repayment of the ineligible financings, false and fictitious financing reports as well as other documents were maintained in the licensee's files to represent financings made to two other small business concerns in the same amount as those reportedly eliminated.

Records made available by the licensee and the Second National Bank of North Miami show Sagera Venture provided financings to the following small business concerns (SBC's):

CHA Good Sports Company, Inc. (CHA)	June 11, 1978	$20,000
7517 Washington Ave. South	July 3, 1978	30,000
Minneapolis, Minnesota	Total	$50,000
Gale Bonaventure Associates (Gale)	July 31, 1978	$ 25,000
16501 Saddle Club Road	October 4,1978	125,000
Fort Lauderdale, Florida	Total	$150,000

As a result of the initial SBA examination of Sagera's books and records, the above two SBC's were found to be ineligible for Section 301(d) financing. The finding of ineligibility was based on the net worth of the SBC principals involved. In a letter of comment dated December 20, 1978, and addressed to Sagera's Board of Directors, SBA detailed its basis for finding the SBC's ineligible and requested Sagera to remove both financings from its portfolio.

In a letter to SBA dated January 10, 1979, and received by the Investment Division through the U.S. mails on January 17, 1979, Gerald Alan Stone represented that CHA had repaid its loan in conformance with SBA's request of December 20, 1978. CHA's repayment was by means of its Check No. 1725 dated January 11, 1979, in the amount of $50,892.11, pay to the order of Sagera Venture Corp. and written by Eugene J. Vacanti, CHA's President. A copy of the check was submitted with the letter to evidence the elimination from Sagera's portfolio of the CHA financing.

During this period, the licensee was applying for a $500,000 loan from SBA to be secured by Sagera's ten year subordinated debentures. The application, on an SBA Form 1022A, Application for Funds, was dated December 6, 1978, and signed Gerald Alan Stone. It was submitted with a cover letter of the same date. Gerald Stone was informed that no action could be taken on his application for funds until the Gale financing had been eliminated from Sagera's portfolio.

In a letter dated January 19, 1979, and received by SBA's Investment Division through the U.S. mails on February

2, 1979, Gerald Stone represented the Gale financing had been repaid in full, including the interest. Repayment was in the form of a check from the National Development and Management Corporation in the amount of $151,112.80 and was signed Gayle S. Wakefield. A copy of the check as well as that of a letter to Mr. Wakefield was enclosed indicating that National Development was purchasing Sagera's investment in Gale Bonaventure.

In a letter dated February 7, 1979, SBA acknowledged Gerald Stone's informing that the two ineligible financings had been eliminated from Sagera's portfolio.

In an Investment Division loan action regarding Sagera's application for funding, reference was made to the above corrective actions taken by the licensee and a $500,000 purchase of the licensee's ten year subordinated debentures was approved by the Agency on February 14, 1979. Treasury Check No. 14,128,669 dated February 12, 1979, in the amount of $500,000 was disbursed to Antonio A. Sobral, Jr. as Sagera's attorney-in-fact on February 16, 1979.

The investigation disclosed the CHA and Gale financings had not been repaid as represented. Non-repayment of the $50,000 and the $150,000 loans was concealed by licensee records generated to represent financings in like amounts to two different SBC's. Adjusting journal entries in the licensee's general journal show the original loan amounts being credited for the CHA ($50,000) and Gale ($125,000) loans with the offsetting debit entries being made to Bill's Trucking and Fair Automotive. No monies were evidenced as being received by Sagera from CHA and for the Gale transaction with National Development and Management Corporation, and no Sagera funds were found to have been disbursed to Bill's Trucking or to Fair Automotive. The adjusting journal entries enabled Sagera to transfer the CHA and Gale Bonaventure loan amounts to Bill's Trucking and Fair Automotive.

Eugene Vacanti, President of CHA Good Sports, stated he had been informed by Gerald Stone that a question had arisen concerning CHA's eligibility and that he (Stone) would have to show SBA that the loan had been repaid to Sagera. According to Mr. Vacanti, Mr. Stone requested a check be made out to Sagera for the loan amount plus the applicable interest. Vacanti said it was understood that Stone would only hold on to the check and would not present it for payment. Vacanti said he could not repay the loan and he reluctantly gave Mr. Stone Check No. 1725 dated January 11, 1979, in the amount of $50,892.11. A review of CHA's statement for Account No. 0-01-26-375 on which the check was drawn at the Bank of Minneapolis and Trust Company shows the check was not presented for payment and that the account opened and closed with an overdraft for the period of December 29, 1978, to January 31, 1979. A review of CHA's cash disbursements journal showed the entry for Check No. 1725 in the amount of $50,892.11 was voided. Mr. Vacanti said he did not know what became of the check and he never saw it again.

The licensee's portfolio records indicate a financing of $50,000 was made to Bill's Trucking of Madison, South Dakota, on January 17, 1979. William Grochow, is the President of Bill's Trucking, which he operates on a side line basis. Mr. Grochow's full time occupation is that as President of the Howard Beef Processing Company, Inc. in Howard, South Dakota, (telephone 605-772-5551). Grochow stated he had borrowed a total of $8500 from Mr. Stone for use in purchasing and repairing of three trucks for use in hauling meat supplies for Howard Beef. Grochow stated the loan was in June of 1979. Records made available by Mr. Grochow show he received $8500 from the Keystone Corp. in June of 1979 which he deposited into the checking account for his trucking operation at the First National Bank in Sioux Falls, South Dakota. A financial statement in the licensee's files indicates Mr. Stone was a 51% owner of Keystone Corp. Other than this, no relationship could be determined between Keystone and Sagera Venture. A review of all Sagera books and financial records that had been subpoenaed of Mr. Gerald Stone on February 11, 1980, as well as the bank records obtained from the Second National Bank of North Miami showed no evidence to support a $50,000 loan disbursement to Bill's Trucking. William

Grochow stated the only funds he borrowed from Mr. Stone was the $8500 through Keystone Corp. Eugene Vacanti stated he was still indebted to Sagera for CHA's loan and was still liable for its payment in accordance with a guaranty dated June 11, 1978, which he had executed. In an adjusting journal entry dated January 31, 1979, offsetting credit and debit memo entries were made in Sagera's general journal regarding a transfer of the loan from CHA Good Sports to Bill's Trucking as of January 17, 1979.

Robert J. Gale, General Partner of Gale Broward Associates, Ltd. (formerly Gale Bonaventure Associates) stated Sagera Venture still retains a limited partnership interest in his firm by virtue of a $25,000 equity investment made by Sagera on July 31, 197[illegible]. Gale Broward is still indebted to Sagera on the basis of a $125,000 loan disbursed to it on October 4, 1978. Records made available by Mr. Gale show the repayment of $25,000 was made on the loan on October 4, 1979, reducing the $125,000 loan balance to $100,000. Gale Broward's financial statement for the period ending December 30, 1979, reported a $125,000 debt payable to a limited partner, identified in a footnote as being Sagera Venture.

Gayle Wakefield was contacted regarding a letter with his signature dated January 19, 1979, which had been submitted by Mr. Stone as evidence of the sale of Sagera's investment in Gale Bonaventure to Wakefield's firm, National Development and Management Corporation. Wakefield acknowledged the letter and that he had written the check for $151,112.30. He said he was the owner of National Development and Management Corporation of Lombard, Illinois (telephone 312-620-5269). He said there had been some talk with Mr. Stone about his, Wakefield's, taking over Sagera's interest in the Gale Broward loan. Wakefield said the transaction was never consummated and he placed a stop order on the check. He said Stone, for some reason or other, did not go through with the transaction.

Wakefield is also the owner of Fair Automotive which is represented in Sagera's records as having received a financing of $150,000 on January 24, 1979. A review of all Sagera's books and financial records disclosed no evidence as to how this financing had been accomplished and/or disbursed. Included in Sagera's records was a stock certificate indicating Sagera owned 250 shares of capital stock of Fair Automotive which was shown as being a Delaware corporation. Mr. Wakefield said he operates Fair Automotive from the same office in Lombard, Illinoi, as National Development and Management Corporation. He said he had held preliminary talks with Mr. Stone about a loan but that it never materialized and that the interest rates were too high. Wakefield said neither he nor any of his companies have ever borrowed funds from Gerry Stone or Sagera Venture. Regarding the stock certificate, Wakefield said he had no knowledge of it, the ownership of Fair Automotive is divided between himself and his immediate family and that Fair Automotive was a Florida corporation and only had 50 shares.

In an adjusting journal entry dated January 21, 1979, offsetting debit and credit memo entries were made in Sagera's general journal recording the transfer of a loan ($125,000), and equity of $25,000 from Gale Bonaventure to Fair Automotive.

In correspondence submitted to SBA through the U.S. Postal System on September 26, 1979, as part of an application for a third funding of $500,000, Gerald Alan Stone represented and certified a financial report showing loans in the form of equity investments had been made to Fair Automotive in February 1979 and Hill's Trucking in May 1979. Omitted and not shown are the loans made and still owed by CHA Good Sports and Gale Bonaventure.

The investigation also disclosed correspondence dated March 15, 1979, from Eugene Vacanti of CHA to John Rykert of SNBNM in which Mr. Vacanti advised that Gerald Stone had done the majority of work in arranging a Farmers Home Administration loan in the amount of $650,000. A portion of the loan was reportedly to be used to repay CHA's indebtedness to Sagera Venture and/or Gerald Stone. Mr. Vacanti stated this did not occur and that the final Farmers Home Administration loan amount was $450,000 which was in the process of being disbursed during the time of the investigation. This was not confirmed with Farmers Home Administration officials.

The funds used for the financings of CHA Good Sports and to Gale Bonaventure originated with loans taken by Sagera Venture from SMBNM which were secured and eventually liquidated with proceeds from the certificates of deposit purchased with SBA leverage funds in May 1978. These funds may have been obtained by Mr. Stone and Sagera by means of possible false statements and verifications submitted to SBA through the U. S. Postal System. Licensee records indicate the above financings were in the form of investments in CHA Good Sports and Gale Bonaventure. CHA Good Sports distributes sporting goods equipment, principally ice hockey equipment, nationwide from its office/warehouse in Minneapolis, Minnesota. Gale Bonaventure's conducts a real estate sales and development business in the Fort Lauderdale, Florida, area. Based on the above, the licensee apparently invested in firms that are involved to some extent in interstate commerce.

Possible Conspiracy to Defraud SBA - Title 18 U.S.C. Sections 371 and 2

Possible Embezzlement of Funds - Title 18 U.S.C. Section 657 and Title 15 U.S.C. Section 645(b)

Possible False Statements - Title 18 U.S.C. Sections 1001, 1006 and Title 15 U.S.C. Section 645(a)

Possible Wire Fraud - Title 18 U.S.C. Section 1343

False Filings Made to SBA - Section 107.1008

Gerald Stone may have conspired with Steven Schmidt, Thomas Roe and John Henrikson to defraud and embezzle SBA funds by making false statements and representations regarding a reported equity financing of $150,000 to Seville Leasing Company on June 21, 1978. The investigation disclosed that $150,000 had actually been loaned to Clayton Management, Inc. (CMI) and deposited into its account at a bank in Hopkins, Minnesota from which a wire transfer withdrawal was then made transferring $50,000 to a Woodhill So-Dak Corp. account at a bank in Sioux Falls, South Dakota. The $100,000 balance appears to have been used by CMI in a computer leasing business.

Licensee portfolio records indicate an equity financing of $150,000 was made to Seville Leasing Company on June 21, 1978, to be used for the purchase of computer and/or software for leasing. Financial reports for the interim period ending November 30, 1978, and the year ending December 31, 1978, include the $150,000 as part of Sagera's equity interest assets. This financial data were considered by SBA in a loan action approving a loan secured by debentures of Sagera in the amount of $500,000 on February 12, 1979.

When Sagera's records were first examined by SBA in October 1978, Thomas Roe, Seville's Vice President, informed that Sagera received an ownership position of 49% for the $150,000 which had been specifically used to purchase IBM equipment which was being leased to Cumberland Electric Membership Corporation and which cost $173,978. Cumberland Electric is located in Clarksville, Tennessee. In a confirmation letter signed September 8, 1978, Steven B. Schmidt, Seville's President, confirmed Sagera Venture had a $150,000 equity investment and owned 49 shares of Seville's stock which were valued at a total subscription or purchase price equal to $150,000.

John Henrikson is Secretary-Treasurer of Seville Leasing as well as the President of Clayton Management, Inc.

The licensee's accounting records for the period prior to December 31, 1978, could not be located by Mr. Stone during the investigation, therefore, the general journal/ledger entries documenting the $150,000 transaction to Seville as reported in the financial reports of November 30 and December 31, 1978, could not be examined.

Bank records at the Second National Bank of North Miami (SNBNM) disclosed Gerald A. Stone had taken out a loan in the amount of $150,000 from the bank in the name of Sagera Venture Corp. on June 21, 1978, the same date as the reported Seville financing.

Security for the loan consisted of the certificate of deposit in the amount of $470,000 which had been purchased with the SBA leverage funds obtained by Mr. Stone and Sagera on May 8, 1978. The certificate, after a series of renewals was used to pay off Sagera's loan from SNBNM on December 6, 1979.

The loan to Sagera was disbursed by means of SNBNM Cashier's Check No. 5194 payable to Sagera Venture Corp. and dated June 21, 1978. The reverse of the check contains an endorsement directing its use as follows:

> "Sagera Venture Corp.
> by Gerald A. Stone, Pres
> Pay to the order of
> Clayton Management
> Corp. only for the
> Account of Deposit
> This check represents
> loan proceeds to CMI, Inc.
> Clayton Management Incorp
> by (signed: John Henrikson)"

The bank stamp shows the check was deposited into an account at Northwestern National Bank of Minneapolis.

John Henrikson is President of Clayton Management, Inc. which shares the same office space with Seville Leasing at 2124 IDS Center in Minneapolis. He stated that the Sagera Venture check to his company was for an interim loan of $100,000 which had been repaid back to Seville Leasing. Mr. Henrikson stated that the $50,000 balance had been transferred to one of Gerry Stone's other corporate accounts in Sioux Falls, South Dakota. Henrikson said he only borrowed $100,000 from Stone in this transaction which he described as a "bridge loan" from Sagera. He said he had obtained his own funds from his bank about a month after the Sagera loan and purchased a certificate of deposit in the name of Sagera Venture Corp. which was subsequently cashed and deposited into the operating account of Seville Leasing.

Bank records made available by Mr. Henrikson showed the $150,000 was deposited into CMI Account No. 86-28-310 at Northwest Bank West on June 21, 1978. The following payments were made against this deposit:

Cashier's Check	Date	Payee	Amount
No. 116083	June 22, 1978	LeMans Corporation 2950 Metro Drive Bloomington, MN	$100,000
Wire Transfer Withdrawal To ----	June 26, 1978 Nat'l Bank of S. Dak. Main Office: Sioux Falls South Dakota For: Woodhill SoDak Corp - 750-1044-460 by: Clayton Mgt.		$ 50,005

The reverse of the Cashier's Check indicates it was deposited into the payee's account at the Union State Bank in Minneapolis, Minnesota. The stamp indicates the check's endorsement constituted partial payment on (The) Aurora Metal Company transaction. A visit to the LeMans Corporation revealed it had ceased operations and its President, Wayne

Helgason, was a patient in a local hospital.

John Henrikson maintained Sagera's loan of $100,000 was interim in nature and was repaid by means of the redemption of Certificate of Deposit No. 75014 dated July 21, 1978, which had been purchased at the Northwestern Bank West in the amount of $100,000. Although the proceeds from the certificate appear to have been credited to the operating account of Seville Leasing at that bank, its relationship to Sagera's CMI loan could not be confirmed since bank records indicated CMI did not finance a certificate of deposit in Sagera's name until July 25, 1978, and the certificate's number on that date was 75015, as opposed to No. 75014 of July 21, 1978. It was not disclosed how Certificate No. 75014 dated July 21, 1978 had been purchased.

Mr. Henrikson said there was no written documentation or agreement confirming the nature and/or basis for the short term loan which his firm, Clayton Management, Inc., had obtained from Sagera Venture as detailed above. He said the terms of the transaction were verbal in nature.

A review of the use of the proceeds which appear to have originated with Certificate of Deposit No. 75015 which Mr. Henrikson had said were credited to Seville's account showed they were substantially applied against a billing from LeMans Corp. which was apparently invoiced originally to Clayton Management, Inc. The serial numbers of the equipment listed on this particular invoice dated August 14, 1978, match the serial numbers of the equipment that was assigned by Mr. Henrikson as security in connection with a Clayton Management loan of $101,478 from Northwestern National Bank West. Leasing documents in the licensee's files indicate the equipment had been assigned to Clayton Management, Inc. by LeMans Corporation on July 28, 1978. The payment for this assignment appears to have been by means of a wire transfer charging Seville's Account No. 86-29-321 at Northwestern Bank West for $72,500, transferring those funds to LeMans' account at Union State Bank. Seville's cash disbursements journal indicates Clayton Management was paid $6,969.56 as an origination fee and the Wright, Roe & Schmidt law firm collected $1,740 for legal services in connection with the transaction which appears to have been for the benefit of Clayton Management, Inc. As a result, it is questionable as to what interests, if any, Seville had in the entire transaction.

Thomas Roe and Steven Schmidt are practicing attorneys and partners in the firm of Wright, Roe & Schmidt, also located at 2124 IDS Towers. A review of Sagera's cash disbursements journal as well as its cancelled checks drawn on its account at SNBNM show five payments totalling $3,500 were made to the law firm for reported legal services during the period of February 1, 1979 to September 12, 1979.

Possible Embezzlement of Funds -
Title 18 U.S.C. Section 657 and
Title 15 U.S.C. Section 645(b)

Possible False Statements -
Title 18 U.S.C. Sections 1001, 1006 and
Title 15 U.S.C. Section 645(a)

Possible Mail Fraud -
Title 18 U.S.C. Section 1341

Possible Wire Fraud -
Title 18 U.S.C. Section 1343

Possible Pattern of Racketeering Activity -
Title 18 U.S.C. Section 1961(1)(B)(4)(5)

Possible Prohibited Activities -
Title 18 U.S.C. Section 1962(a), (b) and (d)

False Filings Made to SBA -
Section 107.1008

Gerald A. Stone possibly embezzled SBA funds and defrauded SBA by converting to his own use and benefit a substantial portion of the $500,000 in leverage funds advanced to Sagera Venture by the Agency on February 16, 1979. Various portfolio financing reports as well as general journal and ledger entries were generated by the licensee to represent financings purportedly made to small business concerns, as well as showing a certificate of deposit that had been invested as idle funds. Of the $500,000, the investigation disclosed Mr. Stone used $187,000 to purchase a yacht, $82,000 was deposited into various personal checking accounts of Mr. Stone's, some of which was used to outfit and equip the yacht for deep sea fishing, and $200,000 was used to purchase a certificate of deposit which was used to collateralize at least one unreported loan for $50,000 to a personal friend of Mr. Stone's. A second unreported loan of $20,000 was also made which when repaid was deposited into a personal account of Mr. Stone's, in a Minneapolis bank and substantially wire transferred to another personal account in a Florida bank against which a payment of $18,923.20 was made to a Minneapolis law firm for payment of a delinquent bank loan of Woodhill Corp. In order to conceal the above transactions which were initially conducted through the use of official bank checks drawn on the Second National Bank of North Miami, no records were retained by Mr. Stone in the licensee's portfolio files other than those for the purported SBC financings.

By means of a cover letter dated December 6, 1978, Gerald Alan Stone submitted an investment plan to SBA as support for a Sagera Venture application for additional funding of $500,000 which was to be secured by subordinated debentures issued by the licensee. Further support consisted of financial reports for the periods ending November 30 and December 31, 1978. Based on the above and in view of the corrective action reportedly taken by Sagera with respect to the initial Agency examination for the period ending September 30, 1978, an Investment Division loan action approving the loan was made on February 12, 1979.

The licensee was informed of the approval in a letter dated February 13, 1979, and on February 16, 1979, Antonio A. Sobral, Jr., as attorney-in-fact, signed a receipt for having received Treasury Check No. 14 128 669 payable to Sagera Venture Corp., Inc., in the amount of $500,000, on behalf of the licensee.

In a general journal entry posted February 28, 1979, the licensee recorded receipt of the $500,000. The offsetting entries posted as disbursements of the funds by Sagera were recorded as follows:

Goldbrick International	$150,000
Michigan Burgers	140,000
Certificate of Deposit at Bank of Mpls. and Trust Co.	150,000
Note Payable	30,000
	470,000
Checking Account of Sagera	30,000
Total	$500,000

Portfolio financing reports maintained in the licensee's files reflect the above financings were made to Goldbrick International in February 1979 and to Michigan Burgers on March 22, 1979. In subsequent financial reports and certifications submitted to SBA through the mails in support of an application for a third funding of $500,000, Gerald Alan Stone represented the licensee obtained an equity interest in Goldbrick (30%) and Michigan Burgers (40%) by means of the above two financings.

L. William Farrell, shown in the licensee records as the owner of Goldbrick International, was contacted and he advised that he had never received a loan or financing from either

Sagera Venture or Gerald Stone.

Tom Perrone, whom licensee records name as the President of Michigan Burgers, was contacted during the second SBA examination of Sagera's books and records. He stated he had never received any money from Stone or Sagera Venture Corporation.

A review of all Sagera books and financial records submitted by Gerald Stone on February 11, 1980, in response to a subpoena issued and served to him as Sagera's President on January 25, 1980, revealed no evidence supporting the above two financings or the portfolio financing reports and accounting entries that had been posted in the licensee's general journal and ledger on February 28, 1979. Also absent was any financial record documenting receipt of the $500,000 Treasury Check from SBA which would further support the entries made in the licensee's general journal.

On February 15, 1980, Gerald Stone stated he could not account for the above other than the fact that some of Sagera's loans had gone bad, one of which was Michigan Burgers. Regarding the disposition of the SBA check for $500,000, Mr. Stone informed he used it to purchase cashier's checks at the Second National Bank of North Miami (SNBNM), however, he did not recall how many checks he had purchased or whom they had been made out to. He claimed he had not retained the records.

The investigation disclosed Mr. Stone presented the Treasury Check at SNBNM and purchased the following three official checks at that bank:

No.	Payee	Date	Amount
29956	G. A. Stone	February 20, 1979	$187,000
29957	G. A. Stone	February 20, 1979	12,000
29958	G. A. Stone	February 20, 1979	300,000
		Total	$499,000

The disposition of the $1,000 difference was not learned.

Check No. 29956 was endorsed by Mr. Stone to the order of Eau Gallie Yacht Basin, Inc. A bank stamp on the reverse of the check indicated it was deposited into Eau Gallie's Account No. 130-408-7 at the Flagship Bank of Melbourne, N. A. Records made available by E. J. Threadgill, President of Eau Gallie Yacht Basin, Inc. of Melbourne, Florida, show the check was used in closing the purchase of a yacht described in the closing statement and purchase order as a 46-foot Hatteras Convertible. The purchase order included the freight expenses associated with transporting the yacht from AMF Hatteras Yachts, High Point, North Carolina, to Eau Gallie's Yacht Basin in Melbourne, Florida. The yacht was purchased in the name of Mr. Gerry Stone, care of Woodhill SoDak Corp. A Western Union Mailgram[*] dated December 22, 1978, had been sent from Minneapolis, Minnesota, to a yacht broker in Fort Lauderdale, Florida, confirming Mr. Stone's offer of $186,000 for the 46-foot Hatteras that had been the subject of earlier discussion. The Mailgram ended with the understanding that payment for the boat would not be made until around the end of January (1979).

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[*] Conditions of the Mailgram were referred to in the Purchase Agreement by the yacht broker.

It was learned the yacht, which was christened Shelby Jean, had been equipped and outfitted for deep sea fishing at Rybovich & Sons Boat Works, Inc. in West Palm Beach, Florida, and was docked at the Old Port Cove Marina in North Palm Beach. A personal financial statement of Gerald Alan Stone and Stephanie Ann Stone (H/W), signed G. A. Stone, November 27, 1979, reported that Stephanie Stone had title to Apartment 3-B at Old Port Cove which had been purchased in 1978 for $76,000 and which had an existing demand mortgage on it for $70,000.

Invoice billings for meals and beverages that were billed to Mr. and Mrs. Gerald A. Stone indicated that they were members of the Old Port Yacht Club in February and March 1979. Old Port Cove is a waterfront condominium community located on U.S. 1 in North Palm Beach, Florida, overlooking Lake Worth and the Atlantic Ocean.

At the Old Port Cove Marina, it was learned a dockage agreement had been entered into whereby the Shelby Jean's owner, Gerry Stone, care of the Woodhill Corp., leased mooring space for the period June 1, 1979 to May 30, 1980, for a rental fee of $3,232.48. The agreement, executed on May 22, 1979 by Mr. Stone, indicated the boat's captain was Charles Hilliard. Charles Hilliard stated the yacht runs charter trips under the name of the Shelby Jean Yacht

Charter Corp. He stated he was licensed by the U.S. Coast Guard to pilot the craft. The license, Number 127459, was issued by the Coast Guard in Miami, Florida, on January 11, 1979, and authorizes Hilliard to operate vessels of 15 tons or less . . . while carrying six or less passengers for hire upon the Gulf of Mexico not more than 60 miles offshore between Apalachicola, Florida and Everglades City, Florida.

Although these cities are on the west coast of Florida facing the Gulf of Mexico, Hilliard said most of the charter trips are on the Atlantic side within a 60 mile radius to the marina, extending out as far east as the Bahamas. He said a trip had been made to Mexico in the summer of 1979. Telephone records of Gerry Stone indicate he had placed several calls from his Phlox Lane residence to Cozumel,* Mexico, in May 1979. A Visa invoice to Mr. Stone indicated he had been billed $1456.75 for a rental car from Avis de Mexico Cozumel. The transaction date was shown as June 3, 1979. The same invoice indicates that Mr. Stone had incurred a bill of $88.4(from the Conch Inn Hotel, Nassau, Bahamas. The transaction date was shown as June 20, 1979. The total bill for this particular Visa statement was $2445.15 and the payment due date was August 31, 1979. Payment of the bill was made in full by Mr. Stone by means of a check dated August 20, 1979, paid to the order of Visa,

* Cozumel is a resort island off the Mexican Yucatan Peninsula. Other telephone calls were placed in April 1979.

drawn and paid on a personal account of Mr. Stone's at the First Marine Bank and Trust Company (of the Palm Beaches).

Regarding the charter company, Mr. Hilliard stated he thought it was a Delaware corporation, and he did not know if he or Gerry Stone was the President or Vice President or vice versa. He said he was supposed to be the majority stockholder but that he had never paid for the stock and never saw any stock certificates. He said he was paid by Mr. Stone in cash and sometimes by checks, however, he had no written employer-employee contract and that everything was based on a verbal agreement between himself and Mr. Stone. He stated his job security did not extend beyond the next day since Stone was in control of every aspect of the yacht's operations. Hilliard added all the charter records were in Minnesota where check writing authority on the charter company's account was held by Gerald Stone. The Shelby Jean Yacht Charter's account is maintained at the Old Port Cove office of the First Marine Bank and Trust. A review of the signature card on its Account No. 5-4161149 at that bank showed it was opened on March 29, 1979, and that Gerald Stone is the only authorized signatory. The business address for the Shelby Jean Yacht Charter Corp. is listed as 2850 Metro Drive, Bloomington, Minnesota, which is the same address of Sagera Venture.

Hilliard stated he did not maintain a log showing where the craft had gone and who was on board, and that there were no brochures which described the yacht's charter business.

The Stones' personal financial statement of November 27, 1979, reports Stephanie Stone as the 100% owner of Shelby Jean Yacht Charter. Mr. and Mrs. Stone have a child, a daughter named Shelby Jean.

Portfolio financing records in the licensee's files as well as financial reports submitted to SBA had represented a financing of $150,000 as being made to North Florida Yachts of St. Peterburg, Florida, in early 1979. The financing was for use as the required deposit while bidding on an off-shore oil well transportation contract. The principal of North Florida Yachts was identified as being L. D. Gonzes. Entries in the licensee's general journal and ledger represented the funds for this financing originated with a $150,000 reduction in Sagera's certificate of deposit balance at SNBNM.

During the second examination of Sagera's records by SBA in November 1979, Mr. Stone stated the bid on the transportation contract had been lost, and he had no idea as to the current whereabouts of Mr. Gonzes nor the location of the $150,000.

The investigation disclosed the reduction in the certificate of deposit balance had actually taken place on December 15, 1978, when Sagera redeemed Certificate of Deposit

No. 07310 in the amount of $470,000 and purchased Certificate No. 07374 in the amount of $320,000. The $150,000 difference had been used to repay SNBNM the $150,000 loan taken on July 21, 1978, in connection with the purported M.C. Investment financing discussed in an above finding. As a result, the actual use of those funds was apparently concealed and misrepresented as being the source for the North Florida Yachts financing. No other evidence was found to support the representations that a financing had been made to North Florida Yachts.

Check No. ?9957 in the amount of $12,000 was endorsed Gerald A. Stone and deposited into his personal Account No. 303-194-5 at the Riverside Community State Bank of Minneapolis on February 21, 1979. A limited review of check payments made on the account during that period showed Check No. 856 in the amount of $1400 had been paid to Charles Hilliard for the period of January 15, 1979 to February 15, 1979. When interviewed, Mr. Hilliard had stated he had been paid sometimes in cash and sometimes by checks. A discussion with Mr. Hilliard had shown he had accepted a job offer from Mr. Stone. Another item paid was Check No. 861 to the order of Scott J. Stone for $2500. Scott J. Stone is Gerald Stone's brother and is President of the Keystone Corp. which occupies the same office suite as Sagera Venture on Metro Drive in Bloomington, Minnesota. Gerald Stone's personal financial statement dated November 27, 1979, reports he has a 51% ownership in Keystone Corp.

SNBNM Check No. 29958 payable to G. A. Stone for $300,000 was endorsed G. A. Stone, pay to the order of Sagera Venture Corp. It was presented for payment at the Bank of Minneapolis and Trust Company (BOMTC) at the Nicollet Mall in Minneapolis. It was used to purchase the following BOMTC Cashier's Checks (C.C.) and Certificate of Deposit (C/D):

C.C. Number	Payee		
83469	G. A. Stone	February 20, 1979	$ 70,000
83468	Sagera Venture Corp.	February 20, 1979	30,000
			$100,000

C/D Number	Payee		
A 2704	Selves	February 20, 1979	$200,000
		Total	$300,000

The $70,000 check was endorsed G. A. Stone, presented for payment on February 26, 1979, and used to purchase the following two BOMTC Cashier's Checks:

C.C. Number	Payee		
83526	G. A. Stone	February 26, 1979	$ 55,000
83527	G. A. Stone	February 26, 1979	15,000
		Total	$ 70,000

The reverse of the $55,000 check shows it was endorsed G. A. Stone and deposited into an account at the First Marine Bank and Trust of the Palm Beaches in Riviera Beach, Florida, where Gerald Stone had a personal account. Checking account records of Gerald Stone indicate Account No. 55603188 is in the name of G. A. Stone, c/o Woodhill SoDak Corp., 2850 Metro Drive, Suite 524, Bloomington, Minnesota. This is also Sagera Venture's address. The bank statement for the period of February 28, 1979 to March 28, 1979, showed the BOMTC check had been deposited on March 2, 1979. Included among the checks drawn and paid against the account at this time were the following, for the apparent use of the Shelby Jean yacht:

Check Number	Payee	Date	Amount
256	Rybovich	2/28/79	$25,000.00
271	Rybovich	3/16/79	2,236.00
257	Murray Bros.	3/2/79	4,144.00
268	Res-Q-Raft Inc.	3/14/79	2,010.00
		Total	$33,390.00

At Rybovich and Sons Boat Works, Inc., in West Palm Beach, Florida, it was learned that the Shelby Jean Yacht Charter, Inc., of 2850 Metro Drive, Bloomington, Minnesota, had an account which opened on March 1, 1979, with a credit of $25,000. Itemized on an invoice dated March 27, 1979, were charges totalling $66,570.08 for assorted equipment that Rybovich had installed on the yacht. Charles Hilliard, Shelby Jean's captain, had informed that he had sailed the yacht to Rybovich where it had been completely outfitted. It was fully equipped for deep sea fishing. The Murray Bros. and Res-Q-Raft Inc. checks were notated for Shelby Jean.

Another check was payable to Gerald Stone for $3,000 and was endorsed Gerald Stone, for deposit only to Account No.

3031945. This is the personal account of Mr. Stone's maintained at the Riverside Community State Bank in Minneapolis. Examination of the bank statement for that account showed a $3,000 deposit was made on March 15, 1979.

Other checks were payable to cash ($4500) and to other payees that were not identifiable by Sagera Venture records.

BOMTC Check No. 83527 to G. A. Stone for $15,000 was endorsed Gerald A. Stone and deposited into his personal Account No. 3031945 on February 27, 1979. As commented above, the $12,000 check from SNBNM of February 20, 1979, as well as the $3,000 check from the First Marine Bank had also been deposited into this account in Minneapolis. Information was not available to show how these funds were used in the conduct of Sagera's 301(d) MESBIC activities.

BOMTC Check No. 83468 for $30,000 was deposited into Sagera's operating Account No. 3086464 at the Second National Bank of North Miami on February 23, 1979. On that same date, Sagera Check No. 1088 was paid to the order of Merit Supply Company.

William Lord and Hal Larson of Merit Supply, Inc. and Rubbermaid Commercial Products, Inc., both located at 1301 Cambridge Street, Hopkins, Minnesota, stated the $20,000 check was the first part of the $30,000 that Gerry Stone had loaned them to get their businesses started. Sagera accounting records show one debit entry to Other Asset ledger Account No. 269 which had been posted February 28, 1979. A handwritten cash disbursement entry records the $20,000 payment as - Other Asset deposit. No other information was available in the licensee's files showing the nature of this transaction or if it had ever been repaid. In addition, the $10,000 difference which Messrs. Lord and Larson said they borrowed could not be accounted for in the review of the available Sagera records. Mr. Lord produced deposit tickets for Merit's Account No. 7153440693 at First Edina National Bank indicating $20,000 and $10,000 had been received on February 20 and May 11, 1979, respectively.

The loan was repaid by means of Merit Supply Company Check No. 381 dated July 9, 1979, payable to the licensee in the amount of $30,395. The check was notated - loan payoff w/interest thru 7/8/79. It was apparently endorsed by Mr. Stone and deposited as part of a total deposit of $38,168.67 into Mr. Stone's personal account at Riverside Community State Bank on July 10, 1979. As indicated on the deposit ticket, other payments that were made as part of that deposit included two from CHA ($846.70 and $700.00) and one from Gale ($3125.00). Mr. Stone had in January 1979 reported these concerns had been eliminated by him from Sagera's portfolio. Elimination had been represented as being by means of total payments of the two loans that had been advanced to the SBC's.

Review of Mr. Stone's account at Riverside shows that on the same date the $38,168.67 deposit was made, a debit was also made to the account transferring by wire, funds of $22,000 to two accounts controlled by Mr. Stone at the First Marine and Trust Company in Riviera Beach, Florida. A credit of $3,000 was made to the Shelby Jean Yacht Charter Account No. 54161149 and a credit of $19,000 was made to Mr. Stone's personal Account No. 55603188.

During the investigation no records were made available by Mr. Stone regarding Shelby Jean Yacht Charter. The use of the $3,000 was not determined.

Available records indicated, a check in the amount of $18,923.20 had been drawn and paid against the $19,000 wire transfer into Mr. Stone's personal account. The payment was Check No. 289 payable to Frederickson Law Firm. On the check's reverse was the notation, Frederickson Law Firm, Client Funds, A. Fortner.

The Frederickson Law Firm is located at 4744 IDS Center in Minneapolis, Minnesota. J. Baillie, of that law firm, informed the check was used to pay a bank client of that law firm for a bad debt on a loan taken by Woodhill Corp. He said the Note for the loan had been signed by Gerald Stone and his brother, Scott Stone. The loan had gone bad and the bank had retained the law firm for collection purposes.

He stated the $18,923.20 was applied to that debt.

BOMTC Certificate of Deposit No. A 2704 payable to Selves, was apparently redeemed and used to purchase C/D No. A 2706 also in the amount of $200,000 on February 23, 1979. BOMTC records indicate a $50,000 reduction in the certificate balance took place on April 25, 1979, when C/D No. A 2717 was redeemed for $200,000 and C/D No. A 2730 was purchased in the amount of $150,000. An entry in the licensee's general journal had indicated a certificate in the amount of $150,000 had been purchased with loans from SBA on February 28, 1979. BOMTC records show the actual purchase in February had been for $200,000. The determination was not made as to what the $50,000 reduction had actually been used for.

BOMTC records indicate the C/D was periodically renewed on a monthly basis, at least up to the period of March 24, 1980. A Certificate No. A 2938 was purchased for $150,000 with the maturity date of April 23, 1980.

Paul Oberstar, Vice President at BOMTC, who handles the Sagera account, stated the certificates were used to collateralize loans to Sagera at the bank. Information provided by the bank on these loans was minimal, and on April 22, 1980, Mr. Oberstar advised that he had been instructed by Gerald Stone on April 18, 1980 to provide no additional information in connection with the investigation.

Prior to this, however, it was disclosed the C/D had secured a loan of $20,000 taken by Sagera Venture on March 14, 1979, to be used by Sagera as an investment in a Pennsylvania business. No repayment program had been established as long as the certificate of deposit continued to secure the credit.

Portfolio records of the licensee indicate a financing of $50,000 had been made to Alyce and Company of Clarendon, Pennsylvania, on March 1, 1979. Sagera records show no evidence as to how this financing had been transacted, and no further connection could be established with the bank's loan of $20,000 subsequent to Mr. Stone's instructions to Mr. Oberstar of April 18, 1980.

Another loan secured by Sagera's C/D was for $51,500 as evidenced by a Note dated May 10, 1979 and executed by Mel D. Sorem, Linda J. Sorem and Gerald A. Stone. Stone's records show no evidence of this loan.

Mel Sorem stated he was a personal friend of Gerald Stone and the loan was taken for his benefit to enable him to get into the meat wholesale business. He said he used the funds to purchase meat from Howard Beef Processors, Inc. of Howard, South Dakota. He had no records to substantiate this claim, however, and he said the business never got off the ground.

Gerald Stone's personal financial statement of November 27, 1979, showed Stephanie Stone was a 24% owner of Howard Beef Processors. Howard Beef is operated by William Grochow, President of Bill's Trucking, purported recipient of a $50,000 financing on January 17, 1979. According to Mr. Grochow, Gerry Stone was Secretary/Treasurer of Howard Beef, and it was he who had an interest in the beef company, owning 23% of its stock.

An SBA Form 860 submitted to the Agency by BOMTC showed that as of August 31, 1979, Sagera had a certificate in the amount of $150,000 at that bank which was securing the loans discussed above. As of March 24, 1980, the licensee still had a C/D for $150,000 at that bank.

Possible False Statements - Title 18 U.S.C. Sections 1001, 1006 and Title 15 U.S.C. Section 645(a)

Possible Mail Fraud - Title 18 U.S.C. Section 1341

False Filings Made to SBA - Section 107.1008

Gerald Stone may have defrauded SBA by submitting possible false statements regarding the licensee's financial data as of December 31, 1978. It had been represented that financings were made to Flynn, Inc. ($150,000) and Executive Airways ($150,000) in December 1978 and to Robert Lloyd, Inc. ($126,000) in October 1978. The information was included in the financial data considered by the Agency when it approved Sagera's application for additional funding of $500,000 on February 12, 1979, and was included in a financial report submitted and received by the Agency's Investment Division through the mails. The investigation disclosed financings were not made to Flynn, Inc. and Executive Air and that Robert Lloyd, Inc. had only received financing of $9,000 from Sagera Venture as of December 31, 1978. Kathleen Flynn, a notary public, may have aided and abetted in concealing the above by signing licensee records that were reviewed by an Agency auditor to evidence the purported $150,000 financing to Flynn, Inc.

Sagera Venture made application for a second funding of $500,000 from SBA in an Application for Funds, SBA Form 1022A, that was executed on December 6, 1978, by Gerald Alan Stone. In a loan action of February 12, 1979, the Agency approved the request and $500,000 was disbursed on February 16, 1979. The loan action report indicated the current financial data of the licensee as of December 31, 1978, included assets in loans and investments of $926,000. An SBA operating official stated this information had been personally submitted by Gerald Stone. A formal financial report, for the licensee's fiscal year ending December 31, 1978, was submitted and received by the Agency through the mails on July 23, 1979. The details of the $926,000 shown as loans and investments as of December 31, 1978, include the following:

Flynn, Inc.	12-14-78	$150,000
Executive Airways	12-27-78	150,000
Robert Lloyd Associates	10-31-78	126,000

Flynn, Inc.

Portfolio records maintained by the licensee which were reviewed during an examination of Sagera records by an Agency auditor, represented the Flynn financing had taken place in November 1978. Various forms were signed K. A. Flynn, including a confirmation letter dated October 20, 1979, submitted to the Agency as part of its examination, representing Sagera Venture Corp. had become a 45% owner by virtue of its investment of $150,000 and, for that reason, there was no loan or debt to be paid. Another document was a partnership agreement apparently executed on November 15, 1978, by G. A. Stone and K. A. Flynn indicating that Sagera Venture was to have a 45% interest in the small concern for $150,000.

Review of Sagera's books and financial records as well as records of the Second National Bank of North Miami (SNBNM) where the licensee maintained its account, showed no evidence supporting the above signed documents that a financing of $150,000 had taken place.

It was learned Kathleen A. Flynn is a notary public in Hennepin County, Minnesota, with a commission which expires on October 20, 1981. Her notary stamp and signature appear on a letter dated March 28, 1978, addressed to SBA, in which Gerald Stone informed he had designated and appointed Jerry B. Baker to serve as Sagera's legally designated agent and/or attorney-in-fact for receiving funds in connection with Sagera's initial funding from SBA of $500,000.

Other documents bearing Kathleen Flynn's signature and notary stamp include an Acknowledgment of an Assignment of Rents, an acknowledgment for individuals in connection with a mortgage deed and a promissory note. These documents were notarized on January 31, 1979, in connection with a property purchase in Dade County, Florida, by Woodhill SoDak Corporation, whose President and Secretary are Gerald A. Stone and Stephanie Stone.

The Flynn signatures on the above documents appear to match those maintained in the licensee's file to evidence the loan of $150,000 to the small business concern, as well as the confirmation letter submitted to the Agency as part of its examination of Sagera's records.

Kathleen Flynn stated Flynn Fashions was an idea she had to get into the dressmaking and a wholesale distribution business, however, the idea never got off the ground. She stated she never received any funds or loans from Gerald Stone or Sagera Venture.

She confirmed she was a notary public and that she had done some notary work for Gerald Stone. She would not confirm her signature on any of the documents in the licensee's files, however, she did acknowledge her notarization of the Woodhill So-Dak documents.

Executive Air

David L. Vincent of Executive Air was contacted. He stated he was an airline pilot and that there had been some discussion of a $150,000 loan which Gerald Stone's company was to provide to Executive Air. He said the talks had been in the spring of 1979, however, the financing plans were never executed and that he never received any funds from either Mr. Stone or Sagera Venture. He said the financing never went beyond a discussion stage.

Licensee portfolio records provided little additional information on Executive Air. A review of all available financial records showed no evidence to support the $150,000 financing as represented in the financial report for the period ending December 31, 1978.

Robert Lloyd Associates

Licensee records indicate a borrowing agreement was executed on January 8, 1979 between Gerald Alan Stone and Robert M. Lloyd, President of Robert Lloyd, Inc. The agreement provides that Sagera Venture would loan $112,500 to Robert Lloyd, Inc., which would in turn reloan the funds to Robert Lloyd Associates, Ltd., a Florida limited partnership. An amendment to the agreement executed by the principals of the partnership on July 10, 1979, increased the amount to be loaned by Sagera to $128,500.

Robert Lloyd Associates, Ltd., a limited partnership formed on October 23, 1978, with Sagera Venture as one of the limited partners, was created as a legal entity to permit Robert Lloyd of Coral Gables, Florida, to borrow funds from Sagera Venture to be used in the building of homes.

Although the licensee had executed an amended agreement to loan Lloyd $128,500 in July 1979, a review of Sagera's financial records and of its operating account at SNBNM. disclosed only $9,000 had been loaned as of December 31, 1978. Further review showed an additional $9,300 had been advanced by Sagera during 1979, making the total $18,300.

In a letter dated October 23, 1979, to the licensee, a closing attorney indicated the following sums as having been advanced by Sagera in accordance with the agreement between the parties:

$ 1,000	capital investment
$ 4,000	deposit on land purchase
$14,000	balance of land purchase
$ 3,000	security for water and sewer deposit
$ 3,937.50	first construction draw
$ 2,500	attorney's fees
$28,437.50	Total

The source of these funds was not confirmed and they could not be reconciled with the $18,300 shown as disbursed from Sagera's operating account at SNBNM.

Examination of the Robert Lloyd, Inc. business Account No. 04-085-04 maintained at the Southeast Bank of Dadeland in South Miami, showed the account was opened with a $100 deposit on December 6, 1978. The only other deposit to the account during that month was a $5,000 credit on December 26, 1978.

Review of all other Sagera financial records showed no evidence to support the $126,000 amount reported as loaned to the small concern in the licensee's financial report for the period ending December 31, 1978.

Use of Initial SBA Leverage Funds -

SBA advanced Sagera Venture initial leverage funds of $500,000 on May 5, 1978. Of that amount, the investigation disclosed $25,000 was used to repay Leonard Lansburgh for an unreported compensation fee which had been advanced by him on behalf of Sagera Venture in April 1978, and $5,000 was credited to the licensee's operating account at the Second National Bank of North Miami (SNBNM). The $470,000 balance was used to purchase renewable certificates of deposit (C/D) at SNBNM which were assigned as security and used for eventual repayment on 6 of 10 loans totalling $554,000 taken at SNBNM during the period of June 8, 1978 to December 21, 1978.

The investigation disclosed the leverage funds of $500,000 received by Sagera Venture on May 5, 1978, were deposited along with a $500,000 transfer from Leonard J. Lansburgh's personal Account No. 226 2927 into Sagera Venture's operating account at SNBNM on May 8, 1978. On the same date a $1 million withdrawal was made and used to purchase C/D No. 06899 for $1 million in the name of Sagera Venture Corp. The C/D was redeemed on May 16, 1978, and distributed as follows:

SNBNM Official Check No. 27228	$ 525,000
Redeposit to Account No. 308 646 4	5,000
SNBNM C/D No. 06918	470,000
Total	$1,000,000

The check for $525,000, payable to Leonard Lansburgh represented repayment of the $500,000 transfer of May 8, 1978, and a $25,000 unreported compensation fee advanced by Mr. Lansburgh on behalf of Sagera Venture in April 1978. The details of this transaction are reported in an above finding.

The $5,000 was credited to Sagera's operating account.

C/D No. 06918 was the first of a series of renewable certificates purchased in the name of Sagera Venture which were used to collateralize and eventually repay 6 of 10 loans taken by the licensee at SNBNM for portfolio financings to small business concerns. The loan amounts and related financings are as follows:

SNBNM Note Number	Date	Amount	Reported SBC Financed
9649	6/8/78	$ 20,000	CHA Good Sports
9676	6/21/78	150,000	Seville Leasing
9703	7/10/78	40,000	CHA Good Sports
9725	7/18/78	140,000	M.C. Investments
9750	8/2/78	25,000	Gale Bonaventure Assoc.
9893	9/22/78	4,000	Robert Lloyd Assoc.
9936	10/4/78	125,000	Gale Bonaventure Assoc.
10162	12/20/78	-0-	Rewrite of #9703 and 9649
10161	12/21/78	5,000	Robert Lloyd Assoc.
10160	12/21/78	45,000	Mara, Inc.
		$554,000	Total

The licensee made periodic renewals of the certificates in the amount of $470,000 until December 15, 1978, when C/D

No. 07310 was redeemed and used as follows:

SNBNM Official Check 29319	$140,000
SNBNM Official Check 29320	10,000
SNBNM C/D No. 07374	320,000
Total	$470,000

The two official checks were payable to the order of the Second National Bank of North Miami and were presented for payment at the bank on December 19, 1978,($140,000) and December 21, 1978,($10,000). Bank records revealed Sagera's Loan No. 9725 for $140,000 taken at the bank on July 18, 1978, was paid on December 19, 1978. A notation on the loan's file jacket indicated the repayment source was a bank check (CC) of SNBNM's. Sagera's Loan No. 9725 is associated with the purported financing to M.C. Investments and is reported in an above finding.

The check for $10,000 appears to have been used in connection with Sagera's Loan No. 10162, taken on December 21, 1978, in the amount of $50,000. This Note was a renewal of Notes 9649 ($20,000) and 9703 ($40,000), totalling $60,000. No new funds were advanced to Sagera and its indebtedness to the bank was apparently reduced by $10,000.

The licensee's certificate balance remained at $320,000 until December 3, 1979, when it was redeemed and used to purchase official Check No. 32671 for $320,000, payable to Great American Bank of Dade County (formerly SNBNM). Bank records disclosed the check was processed by the bank's loan and discount teller on December 5, 1979, and applied against five of the above loans of Sagera, totalling $313,999.59. SNBNH bank records did not account for the $6,000.41 difference between the $320,000 payment and the licensee's debt reduction.

As of February 7, 1980, Sagera had an unpaid balance on Notes No. 10160 ($39,029.60) and 10162 ($43,907.68).

Finevalor Capital Corp
02/02-0387
New York, New York

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SUMMARY

Regulatory matters disclosed by this examination are as follows:

1. Cost of money -- Sections 107.301(c)(1)(ii),(c)(3), and (c)(5) two instances
   The licensee restructured its financings to two existing portfolio concerns. The new terms of both financings show an interest rate that exceeded SBA's maximum allowable cost of money (Page 5).

2. Filing of SBA Form 468 -- Section 107.1102(e)
   The licensee did not submit to SBA at the end of the fiscal year, its Financial Report, SBA Form 468 (Page 8).

3. Books of account not maintained in accordance with SBA's System of Account Classification -- Section 107.1102(a)--ten instances
   The licensee's books of account were not being maintained in accordance with SBA's System of Account Classification (Page 9).

4. Inadequate internal controls over securities -- Section 107.1103(a) and (b)(corrected)--four instances
   The licensee did not maintain dual control over all of its securities (Page 9).

5. Maintenance of books and records by licensee -- Section 107.1102(a) (corrected)
   The licensee's books of account were not posted on a current basis (Page 9).

— ———

Significant matters disclosed by this examination are as follows:

1. Capital impairment
   The examination disclosed that, as of September 30, 1981, the licensee's capital is impaired. Such impairment is not reflected in the licensee's books of account and related records (Page 10).

2. Character eligibility of Zuan Zavala, president
   It is significant to note, that a pre-licensing check of the Federal Bureau of Investigation (FBI) files disclosed numerous allegations of wrongdoing, including charges of fraud and embezzlement of public funds by Juan Zavala, chairman of the board, president and sole owner of the licensee. SBA, however, primarily based on documents obtained by the licensee from the governments of France and Switzerland, determined that there is no evidence available at this time upon which an adverse character eligibility determination can be based, thereby precluding Mr. Zavala's association with the licensee (Page 19).

A recommendation made includes the following:

> Examination disclosed that the licensee's financial condition is unsound, and that funding of the licensee, at this time, would involve an extraordinary degree of risk.
>
> In view of the above, it is recommended that consideration be given to withholding SBA leverage, until the licensee has satisfactorily demonstrated to SBA that it is a viable business entity (Page 22).

The results of the examination were discussed with Juan Zavala, chairman of the board and president of the licensee. His comments have been included in the report where appropriate.

INTRODUCTION AND SCOPE OF EXAMINATION

Finevalor Capital Corporation was examined for the 15-month period ended September 30, 1981. The examination included a review of available information on financings made through November 13, 1981, the exit conference date.

Books of account, consisting of a general ledger and books of original entry, were examined. Cash and deposits in financial institutions were confirmed.

A review was made of internal control procedures and investment policies and practices.

The examination also included a review of loan files, corporate stock records, and other pertinent documents. Loans and investments were verified by direct confirmation. Also, credit reports were obtained and visits made to portfolio concerns.

A comparative balance sheet and a schedule of officers and directors are included in the report as exhibits.

The information contained in the examination report is based upon the books and records of the licensee, upon statements made by directors, officers, and employees of the licensee, and upon information obtained from other sources believed to be reliable.

BACKGROUND AND MANAGEMENT PRACTICES

Finevalor Capital Corporation was incorporated under the laws of the State of New York on April 2, 1979, and was licensed by the Small Business Administration (SBA) on July 1, 1980.

The licensee's initial and current capitalization of $1,020,000, was derived from the sale of 200 shares of common stock to Mr. Juan Zavala, president and sole stockholder of the licensee.

The licensee's office is located within the offices of Sentrate Corp. (Sentrate), an affiliated concern, at 745 Fifth Avenue, New York, New York. In addition to its private office space, the licensee also shares certain other office facilities and common areas with Sylvia Couture Ltd. (SCL), an associated concern as described below.

The licensee is charged $1,000 per month for the use of such premises. However, the licensee has not paid or accrued such expense since March 31, 1981. Mr. Zavala stated that the payment of such back-charges ($6,000 at September 30, 1981), is contingent upon the licensee's receipt of SBA leverage. He further stated that if such leverage is obtained, the licensee's office will be expanded to three rooms (now one room), by taking over the space formerly occupied by Exact Value, Inc. (EVI), an associated concern. It is anticipated that the licensee's monthly rental will be increased to $4,000 from $1,000 per month, or $48,000 annually, as a result of such expansion. In the event such leverage is not obtained, the licensee's current office space will either be subletted or turned over to the management of the building, with the licensee taking over the space now occupied by SCL.

The daily operation of the licensee is managed by Juan Zavala, who is also the sole stockholder of Sentrate, a concern involved in the importing of manufactured goods and jewelry, including gold bracelets, gold necklaces, gold chains and diamonds. Sentrate also imports corduroy and jean fabrics from the Far East. In addition, Sentrate exports piece goods such as pants and shirts to France, Germany and Holland, and provides financial and factoring services for a commission.

Mr. Zavala's son, Miguel, is the sole owner of EVI, a concern which is now only engaged in the importing and exporting of general merchandise, mainly gold jewelry and diamonds. Mr. Zavala stated that his son's firm moved to a new location, and has discontinued its commercial factoring operations. In addition, Mr. Zavala's wife, Sylvia, owns 100 percent of SCL, a concern engaged in importing women's silk dresses.

The licensee's Proposal to Operate states that the licensee will provide assistance and financial and management expertise to new and expanding small businesses, particularly those companies in the chemical, jewelry, textile and apparel industries. The licensee's business is to be conducted primarily in the New York metropolitan area and its fiscal year is to begin April 1 and end March 31, each year.

As of September 30, 1981, the licensee had a serious cash problem, as its sole liquid asset was an operating account with a cash balance of $189. Such problem is so acute that the licensee has: (1) not paid any of its obligations to its attorney and independent accountant (since inception), (2) fired its only bookkeeper, and (3) discontinued payment of officer salaries. To date, cash flow from the licensee's debt security investments, approximately $1 million, has been nil, although such investments were designed to provide a steady stream of cash receipts commencing on July 1, 1980.

During the examination period, the licensee did not provide any financings and was relatively inactive.

The licensee's portfolio, as of September 30, 1981, consisted of six debt security financings to six small concerns, the total financings of which amounted to $1,009,940. However, review disclosed that two of the six concerns have discontinued operations. Further, due to financial difficulties, the remaining four concerns did not make any payments in accordance with the terms of their respective agreements, thereby causing the licensee to restructure the terms of such financings. As a result of such situation, the licensee's capital has become impaired (see "Significant Matters" section of the report).

As of November 13, 1981, the exit conference date, the licensee did not have any outstanding commitments to finance small concerns.

Mr. Zavala stated that the licensee plans to decrease its future investment risks by providing smaller financings.

REGULATORY MATTERS

All matters reported in this section are of a regulatory nature and have been classified under the applicable section of the regulations for identification purposes and to facilitate relating the circumstances found to the specific requirements of the regulations. Accordingly, these matters should not be considered as violations of the Small Business Investment Act or regulations until or unless determined to be such through administrative or judicial processes.

Cost of money -- Sections 107.301(c)(1)(ii),(c)(3), and (c)(5) -- two instances

The licensee restructured its financings to two existing portfolio concerns. The new terms of both financings show an interest rate that exceeded SBA's maximum allowable cost of money.

Section 107.301(c)(1)(ii) of the regulations states that subject to lower rates prescribed by local law, if the current interest rate for 10-year debentures sold by licensees to the Federal Financing Bank (FFB) is in excess of eight percent, the maximum cost of money for any such financing made during the period that such rate is in effect shall not exceed a rate equal to the sum of the FFB rate plus seven percentage points, but rounded off to the next lower eighth of one percent.

Section 107.301(c)(3) of the regulations states that a financing that provides for a fluctuating interest rate is nevertheless subject to the maximum cost limitation in effect at the time of commitment or of first disbursement if no legally binding commitment was issued.

Section 107.301(c)(5) of the regulations states that cost of financing includes all interest, discount, and all fees, commissions, and similar charges imposed directly or indirectly by the licensee on the small concern.

The specific details follow:

I.G.E. TRADING CO., INC. (IGE)

On May 30, 1980, the licensee provided a $200,000 debt security financing to IGE, at 18 percent per annum. The note was to be liquidated by 60 equal monthly principal payments of $3,333.33, plus interest on the entire unpaid balance. Such payments were scheduled to commence on August 1, 1980. However, IGE was unable to make such payments due to financial difficulties, and on January 31, 1981, the licensee restructured IGE's indebtedness, as follows:

1. Interest on the loan was increased from 18 percent to 20 percent per annum.

2. The principal of the loan was increased by $18,400, representing accrued but unpaid interest, making the principal sum $218,400.

3. The principal sum of $218,400 shall be repaid in 60 installments, as set forth in the original agreement, commencing October 31, 1981.

SBA's maximum allowable cost of money rate for financings made during January 1981 was 19-¼ percent. The licensee charged IGE excessive interest as follows:

Licensee rate per agreement (percent)	SBA maximum rate (percent)	Excessive interest rate charged (percent)
20.0	19.25	.75

During an interview, Carl Klein, sole shareholder of IGE, confirmed the new terms of financing as stated above. Mr. Klein further stated that IGE now operates as a trader of precious metals from his personal residence in Rockaway, New Jersey. IGE used the funds to expand its business operations, specifically via inventory purchases.

COOKS' NOVELTIES, INC. (CNI)

On May 19, 1980, the licensee provided a $198,500 debt security financing to CNI, at 18 percent per annum. The note was to be liquidated by 60 equal monthly principal payments of $3,308.33, plus interest on the entire unpaid balance. Such payments were scheduled to commence on July [illegible], 1980. However, CNI was unable to make such payments due to financial difficulties, and on February 1, 1981, the licensee restructured CNI's indebtedness, as follows:

1. Interest on the loan was increased from 18 percent to 20 percent per annum.

2. The principal of the loan was increased by $21,339 representing accrued but unpaid interest, making the principal sum $219,839.

3. The principal sum of $219,839 shall be repaid in 60 installments, as set forth in the original agreement, commencing November 15, 1981.

SBA's maximum allowable cost of money rate for financings made during February 1981 was 19-3/4 percent. The licensee charged CNI excessive interest as follows:

Licensee rate per agreement (percent)	SBA maximum rate (percent)	Excessive interest rate (percent)
20.0	19.75	.25

CNI now operates as a distributor of food products, and is located in Long Island City, New York.

During a visit to the premises of CNI, Stanley Gruen, manager, confirmed the new terms of financing as stated above. CNI used the funds to open a second store (now closed), purchase inventory and to conduct an advertising campaign.

Mr. Zavala stated that a reduction in the rates charged to IGE and CNI will only be made upon the licensee's receipt of SBA leverage.

Filing of SBA Form 468 -- Section 107.1102(e)

The licensee did not submit to SBA at the end of the fiscal year, its Financial Report, SBA Form 468.

Section 107.1102(e) of the regulations states that each licensee shall submit to SBA, at the end of each fiscal year, a report containing financial statements for the fiscal year (Part I of SBA Form 468) as well as management information (Part II of SBA Form 468).

The licensee did not submit to SBA at the end of the fiscal year, its Financial Report, SBA Form 468. The licensee was incorporated under the laws of the State of New York on April 2, 1979, and was licensed by SBA on July 1, 1980. The licensee's fiscal year ended on March 31, 1981.

During a meeting at the licensee's office, Bernard Sandler, senior partner in the accounting firm of Shelowitz, Sandler & Co., CPAs (S&S), stated that S&S started the first audit of the licensee in April 1981. However, the examination was terminated shortly thereafter when Mr. Zavala advised S&S that payment of the audit fee was contingent upon the licensee's receipt of SBA leverage. He further stated that during September 1981, the licensee rehired S&S to complete the annual audit and report the results thereof. Such examination is now in the process of being completed.

Mr. Zavala stated that the licensee cancelled the original audit engagement because it would have been a large and unnecessary expense if SBA determined that the licensee was not eligible to remain in the SBIC program.

Mr. Zavala also stated that the licensee's accountant will file its Financial Report, SBA Form 468, with SBA in the near future.

Books of account not maintained in accordance with SBA's System of Account Classification -- Section 107.1102(a)--ten instances

The licensee's books of account were not being maintained in accordance with SBA's System of Account Classification.

Section 107.1102(a) of the regulations states that current financial records including books of account are to be maintained in all material respects in accordance with SBA's System of Account Classification.

A review of the licensee's books of account showed that 10 accounts in the general ledger were misclassified.

Mr. Zavala stated that the licensee will make the necessary corrections to conform with SBA's System of Account Classification.

Inadequate internal controls over securities -- Section 107.1103(a) and (b) (corrected)--four instances

The licensee did not maintain dual control over all of its securities.

Review disclosed that the licensee maintained all four of its original refinancing agreements with its attorney, Steven Harvis.

Subsequently, the licensee obtained the agreements from Mr. Harvis and stored them in its safe deposit box at Citibank, New York, New York, thereby correcting the matter.

Maintenance of books and records by licensee -- Section 107.1102(a)(corrected)

The licensee's books of account were not posted on a current basis.

The on-site examination of the licensee began during the month of October 1981, however, the general ledger and cash receipts and disbursements journals were only posted through March 31, 1981.

Upon being advised of this matter, the licensee obtained the services of a temporary bookkeeper to post both accruals for the year ended March 31, 1981, and all cash transactions for the period April 1, 1981, through September 30, 1981.

SIGNIFICANT MATTERS

Capital Impairment

The examination disclosed that, as of September 30, 1981, the licensee's capital is impaired. Such impairment is not reflected in the licensee's books of account and related records.

Although the licensee has been in existence for only one year, as of September 30, 1981, the licensee's retained earnings deficit of $523,976, was equal to 51.4 percent of the licensee's private capital of $1,020,000. However, such deficit does not include the obligations of three portfolio concerns which defaulted on their respective loans, without having made any principal or interest payments, and are now covered under the umbrella of restructured financing agreements. Therefore, the licensee's actual deficit may be $1,049,696, or 102.9 percent of private capital.

The deficits, restructured and actual, included an adjustment of delinquent principal and interest of portfolio concerns, net of reserves, of $233,172 and $758,892, respectively. Computation of the deficits, as adjusted, as of September 30, 1981, are shown below:

	September 30, 1981			
	Restructured		Actual	
Retained earnings deficit -- per books		$ 290,804		$ 290,804
Delinquent portfolio accounts:				
Delinquent principal	$516,440 1/		$1,009,940 1/	
Less: allowance on books included above	341,000	$ 175,440	341,000	$ 668,940
Delinquent interest	$ 92,732		$ 124,952	
Less: allowance on books included above	35,000 2/	57,732	35,000 2/	89,952
Adjustment for delinquent principal and interest--(addition to allowance on books		$ 233,172		$ 758,892

	Restructured	Actual
Total deficit -- as adjusted --9/30/81	$ 523,976	$1,049,696
Private capital -- 9/30/81	$1,020,000	$1,020,000
Percentage of deficit to private capital	51.4	102.9

1/ Delinquent principal was adjusted by an allowance for bad debts of $341,000. Such amount was deducted from income at March 31, 1981, and includes the write-off of loans made to Beaumont Management, Inc. (BMI), $150,000, and Emcee Diamond Creations, Inc. (EDCI), $166,440.

2/. Represents all interest accrued on loans to BMI and EDCI through March 31, 1981.

A schedule of the delinquent accounts, as of September 30, 1981, is as follows:

SCHEDULE OF DELINQUENT ACCOUNTS

September 30, 1981

Small concern	Principal balance 9/30/81		Restructured delinquent Principal 9/30/81	Restructured delinquent Interest 9/30/81		Actual delinquent Principal 9/30/81	Actual delinquent Interest 9/30/81
Emcee Diamond Creations, Inc. (EDCI)	$ 166,440	1/	$166,440	$14,449		$ 166,440	$ 14,449
Beaumont Management, Inc. (BMI)	150,000	1/	150,000	20,550		150,000	20,550
I.G.E. Trading Co., Inc. (IGE)	200,000	2/	200,000	25,559		200,000	25,559
Cooks' Novelties Inc. (CNI)	198,500	3/	-0-	21,339	4/	198,500	28,545
Shoot-In-Tuscon (SIT)	180,000	3/	-0-	6,611	4/	180,000	21,874
La Reine Pedauque (LRP)	115,000	3/	-0-	4,224	4/	115,000	13,975
Totals	$1,009,940		$516,440	$92,732		$1,009,940	$124,952

1/ Small concern discontinued operations.

2/ Small concern defaulted on both the original and restructured loans, without having made any principal or interest payments.

3/ The principal and interest balance due from any concern that had not made a principal or interest payment for a period in excess of one year, was considered to be entirely delinquent, as of September 30, 1981. The licensee restructured the terms of financing for each of these three concerns, which defaulted on their loans, without having made any principal or interest payments. Under the restructured agreements, no payments were due at the time of review.

4/ Represents an adjustment to allowance for uncollectible interest receivable not provided for by the licensee. Such delinquent interest was capitalized by the licensee under a refinancing agreement. The increase to the allowance for uncollectible interest receivable is in accordance with Appendix C, System of Account Classification, in reference to account 383--other deferred credits. This account explanation provides that when recovery thereon is doubtful, an addition to the allowance for uncollectible interest receivable should be made in an amount equivalent to the accrual of interest receivable. As of September 30, 1981, the licensee's books of account did not reflect the capitalization of such interest.

Current financial information, where available, covering the above portfolio concerns, together with the current status of the company, and the licensee's comments regarding each of the delinquent accounts, in the same order as shown in the above schedule, follows:

EDCI

On May 19, 1980, the licensee provided a $170,000 debt security financing to EDCI, a small concern engaged in the trading of precious metals in New York, New York. The agreement provided for 60 monthly installments of principal and interest commencing July 1, 1980. However, EDCI discontinued making such payments on August 1, 1980, after its second payment.

A follow-up visit to the premises of EDCI showed that the small concern has discontinued operations.

Mr. Zavala stated that Melvin Klar, sole shareholder of EDCI, became ill while on business in Israel, and has not yet returned to the United States.

On a second occasion, Mr. Zavala stated the EDCI ran into financial difficulties because it could not recover the cost of its gold and diamond inventories, due to the sharp decline in the market value of such precious metals.

During an interview, Steven Harvis, attorney for the licensee, stated that Mr. Klar and his family left the country with over $1 million in bank loans and its entire inventory of precious metals, and that Mr. Klar's whereabouts are unknown.

Mr. Zavala stated that Mr. Klar has been a personal friend for approximately 12 years.

Mr. Zavala further stated that the licensee is in the process of writing off its entire investment in EDCI.

BMI

On May 19, 1980, the licensee provided a $150,000 debt security financing to BMI, a modelling agency located in New York, New York. The agreement provided for 60 monthly installments of principal and interest commencing July 1, 1980. However, BMI has not made any payments against such indebtedness.

A follow-up visit to the premises of BMI disclosed that the small concern discontinued operations. Such premises are now occupied by L'Image, which is also a modelling agency. Mr. Ed Feldman, principal of L'Image, stated that Jeremy Foster, sole shareholder of BMI, abandoned the business leaving behind approximately 200 judgements from banks, etc. He further stated that Mr. Foster is a desperado and a thief, who is now believed to be hiding in Vancouver, British Columbia.

Mr. Zavala stated that a substantial amount of BMI's receivables proved to be uncollectible, due to certain textile bankruptcies. He further stated that the licensee is in the process of writing off its entire investment in BMI.

IGE

On May 30, 1980, the licensee provided a $200,000 debt security financing to IGE, a small concern engaged in the trading of precious metals. The agreement provided for 60 monthly installments of principal and interest commencing August 1, 1980. However, IGE was unable to make such payments, and on January 31, 1981, the licensee restructured IGE's indebtedness, as follows:

accrued but unpaid interest, making the principal sum $218,400.

2. The interest rate was increased to 20 percent from 18 percent per annum. The new agreement also provided for 60 monthly installments of principal and interest commencing October 31, 1981. However, as of November 13, 1981, the exit conference date, IGE did not make such payment, and is now in default, under the provisions of such agreement.

The latest unaudited financial statement available covering the nine-month period ended September 30, 1981, shows sales of $678,531 and a net profit of $46,107. Total assets of $571,452 primarily consisted of receivables of $279,863 and inventory $187,501. The financial statement also showed that total liabilities amounted to $373,371 and a net worth of $198,081. However, comparison to IGE's financial statement as of October 31, 1979, showed a deteriorating financial situation:

1. Receivables increased 30 percent to $279,863 from $216,000. Such increase is ominous in that it occurred during a period of declining sales.

2. Stockholders' equity decreased 39 percent to $198,081 from $322,835.

3. Gross profit margin decreased to 36.6 percent from 40.8 percent, or 4.2 percent.

The comparison also identified certain peculiarities, as follows:

1. Although IGE operates from the personal residence of Carl Klein, sole shareholder, furniture and fixtures increased to $44,179 from $2,000.

2. Capital stock decreased to $100,000 from $150,000, or 33-1/3 percent, although there was no change in the number of outstanding shares of common stock.

During an interview, Mr. Klein stated that IGE is operating from his personal residence to lower costs. He also stated that his salesmen travel to retail stores throughout the country, and thus it was considered unnecessary to maintain a showroom in New York City. He further stated that IGE requested an amendment to its original financing agreement to improve cash flow. He concluded by stating that, hopefully, IGE will make its first payment against such indebtendess on December 1, 1981.

Mr. Zavala stated that the current economic climate caused a 50 percent devaluation of IGE's inventory. He also cited difficulties in collecting amounts due from clients, as the jewelry industry is experiencing an unprecedented number of bankruptcies.

CNI

On May 19, 1980, the licensee provided a $198,500 debt security financing to CNI, a distributor of food products. CNI is located in Long Island City, New York. The agreement provided for 60 monthly installments of principal and interest commencing July 1, 1980. However, CNI was unable to make such payments due to financial difficulties, and on February 1, 1981, the licensee restructured CNI's indebtedness by: (1) capitalizing accrued but unpaid interest of $21,839, and (2) increasing the interest rate to 20 percent from 18 percent per annum. Repayment of such debt shall commence on November 15, 1981.

The latest unaudited financial statement available covering the three-month period ended September 30, 1981, shows sales of $405,600 and net income of $19,179. Total assets of $547,009 primarily consisted of receivables of $193,967 and inventory $289,563. The financial statement also showed total liabilities of $331,731 and a net worth of $215,278.

During a visit to the premises of CNI, Stanley Gruen, manager, stated that he was hired to implement a new marketing strategy, i.e., door-to-door selling of non-perishable food products. He explained that such concept utilizes econoline vans for the transportation and storage of the food products. He further stated that CNI has had cash problems, as its previous venture as a discount grocer in Brooklyn, New York was unsuccessful.

Mr. Gruen also stated that all of CNI's vans were on the road. Therefore, verification of CNI's inventory was not possible during the visit.

Mr. Zavala stated that CNI is developing an efficient system of importing and selling food products. Such system should enable CNI to succeed.

SIT

On May 19, 1980, the licensee provided a $180,000 debt security to SIT, a small concern involved in the production of motion pictures. SIT is located in Los Angeles, California. The agreement provided for 60 monthly installments of principal and interest commencing July 1, 1980. However, SIT was unable to make such payments due to financial difficulties, and on November 1, 1980, the licensee restructured SIT's indebtedness by: (1) capitalizing accrued but unpaid interest of $6,611, and (2) increasing the interest rate to 16 percent from 10-3/4 percent per annum. Repayment of such debt shall commence on January 1, 1982, or 14 months from the date of refinancing.

The latest unaudited financial statement covering the six-month period ended August 31, 1981, shows sales of $713,019 and net income of $48,706. Total assets of $604,926 primarily consisted of receivables of $425,516 and inventory $81,567. The financial statement also showed total liabilities of $273,283 and partners' equity of $331,643.

During an interview with Mr. Lewenstein, partner, he stated that SIT had the financial capability to comply with the original payment terms under the agreement. However, after discussions with Mr. Zavala, SIT elected to pursue a more aggressive rate of expansion, and thus elected to amend the original terms of the financing, notwithstanding the substantial increase in interest charges. SIT management determined that such charges would be fully covered by an increase in revenues from television and theatre sales.

Mr. Zavala stated that SIT is now in excellent shape because they recently signed several movie contracts.

LRP

On June 12, 1980, the licensee provided a $115,000 debt security financing to LRP, a small concern that operates a French restaurant in New York, New York. The agreement provided for 60 monthly installments of principal and interest commencing July 1, 1980. However, LRP was unable to make such payments due to financial difficulties, and on October 31, 1980, the licensee restructured LRP's indebtedness by: (1) capitalizing accrued but unpaid interest of $4,224, and (2) increasing the interest rate to 16 percent from 10-3/4 percent per annum. Repayment of such debt shall commence on January 1, 1982, or 14 months from the date of refinancing.

The latest unaudited financial statement covering the fiscal year ended September 30, 1981, shows sales of $535,820 and net income of $20,508. Total assets of $247,401 primarily consisted of furniture and fixtures $111,323, receivables $65,863 and inventory $41,810. The financial statement also showed total liabilities of $157,496 and entrepreneurial capital of $89,905.

During a visit to the premises of LRP, Adrian Ackerman, entrepreneur, stated that due to an unexpected opportunity for further expansion, the floor above the restaurant became available, LRP requested deferment of initially scheduled payments to prevent a shortage of working capital.

Mr. Zavala stated that LRP has become a popular New York eatery, and that the licensee does not anticipate any losses on this investment.

Further scrutiny of the four financial statements discussed above disclosed certain peculiarities, as follows:

1. All four of the financial statements were prepared on plain 8-½" x 11" bond paper of similar quality.
2. None of the four financial statements contained the identification of an independent preparer or the letterhead of the small concern.
3. The terminology and presentation of financial data was similar for all four financial statements.

4. It appears that three of the four financial statements were typed with the same typewriter.

5. All four financial statements were shipped together by the licensee subsequent to the exit conference, although they had been requested two weeks prior to the start of the examination.

Also, the licensee's capital may be further impaired in that due to a serious liquidity problem, only $189 in cash, the licensee has stopped paying its regular operating expenses since March 31, 1981, e.g., rent and salaries, etc. Such expenses are currently being treated as contingencies, i.e., only payable upon the licensee's receipt of SBA leverage, and are not reflected in the licensee's books of account. As of September 30, 1981, such expenses amounted to $30,060 (salaries $21,060 and rent $9,000). The licensee has also disconnected both telephones located in its designated office space. However, the licensee continues to maintain a separate listed telephone number. Additionally, the licensee has not paid any bills for legal and accounting expenses, including all organization costs. As of September 30, 1981, such obligations amounted to $23,125.

Further, it appears that such restructuring of the above-mentioned financings was merely for cosmetic purposes, in that all four concerns defaulted without having made any principal or interest payments. Yet, the new agreements, in effect, increased the principal amount of each loan, by capitalizing accrued but unpaid interest, and provided for significantly higher interest rates. Such agreements also granted each concern a moratorium on principal and interest payments ranging from seven to 14 months. Historically, such refinancing agreements have been used as a device to camouflage a capital impairment situation.

In view of the above, it appears that without a substantial injection of additional capital, the licensee will not be able to operate as a going and viable concern.

Character eligibility of Juan Zavala, president

It is significant to note, that a pre-licensing check of the Federal Bureau of Investigation (FBI) files disclosed numerous allegations of wrongdoing, including charges of fraud and embezzlement of public funds by Juan Zavala,chairman of the board, president and sole owner of the licensee. SBA, however, primarily based on documents obtained by the licensee from the governments of France and Switzerland, determined that there is no evidence available at this time upon which an adverse character eligibility determination can be based, thereby precluding Mr. Zavala's association with the licensee.

Mr. Zavala was born in Romania on January 21, 1921, and has a degree in Engineering from Belgium College, Brussels, Belgium. Mr. Zavala has been living in America as a resident alien since 1975. Mr. Zavala plans to stay in the United States and plans eventually to become an American citizen. During the prior 13 years, 1962 to 1975, Mr. Zavala lived in Dusseldorf, West Germany, where he operated as a private banker.

Details concerning the specific allegations provided by confidential overseas informants to the FBI are as follows:

1. In 1963, the French authorities requested the cooperation of the Swiss authorities in investigating a case against Mr. Zavala and several others who were charged with violating laws concerning checks, bankruptcy, diversion, fraud, embezzlement of public funds, conspiracy, and receiving and swindling.

2. In 1963, Mr. Zavala was the defendant in 17 suits, of which 15 were by a Geneva, Switzerland banking institution, for a total of $190,000.

3. In 1964, Mr. Zaval was the defendant in suits totalling about $170,000, although he contested these suits by alleging that his permanent residence was not in Switzerland but Belgium. During the following year, the bankruptcy office sold a villa in which Mr. Zavala had lived.

4. In 1955, Mr. Zavala took refuge in Switzerland to escape French justice, "being implicated in a case of diversion and fraud which probably was not prosecuted", and that Mr. Zavala was "more or less involved in the banking affairs of Trujillo, the ex-Dominican dictator".

5. In 1958, "under conditions which have remained mysterious", Mr. Zavala obtained a Panamanian passport after having been named honorary Counsul of Panama in Madras, India, although it was apparent that he was never in Madras.

6. In 1962, in Nicaragua, "in circumstances which were similarly suspicious", he obtained a Nicaraguan diplomatic passport valid indefinitely, which Mr. Zavala insisted had been issued to him legally.

7. In 1963, Mr. Zavala had in his custody, several Panamanian consulate seals and a total of 16 Nicaraguan and Panamanian passports, 14 of which were blank and two of which were filled out in fictitious names, and that Mr. Zavala later insisted that he had come into the possession of these items legally.

On June 5, 1980, SBA requested its Office of General Counsel to review the information cited above.

On June 26, 1980, General Counsel reported that: (1) there is no specific evidence, as far as we know, that Mr. Zavala has ever been arrested or convicted; (2) it cannot objectively evaluate the nature of the activities concerning the blank passports, consulate seals and passports issued in fictitious names, and (3) the fact that many suits, apparently civil suits only, were filed against Mr. Zavala in Switzerland, in the mid-1960s, is also difficult to evaluate inasmuch as those suits could have reflected business failure as easily as illegal conduct. In short, this case has produced much "smoke" but based on the criteria contemplated by section 7(e) of SOP 90-20, there is no evidence upon which an adverse character eligibility determination can be based, thereby precluding Mr. Zavala's association with the licensee.

On January 22, 1981, the office of the Assistant Inspector General for Investigations issued the results of its investigative evaluation of the licensee and its principal, Juan Zavala. The evaluation included communications, through INTERPOL, with several countries where Mr. Zavala had known antecedents. The report lists the significant information obtained, and includes a recommendation that the office of the Assistant Inspector General for Audits consider including in its Audit Report a recommendation that this SBIC license be revoked (see exhibit 3 of the report).

Subsequently, SBA advised the licensee of certain allegations included in the report.

The licensee rebutted such allegations by obtaining and submitting certain documents to SBA for review, as follows:

1. A report from the Ministry of Justice of the French Republic which indicates that Mr. Zavala has no criminal record in France.

2. A report from the Central Office of Swiss Police which indicates that their judicial files show no record of Mr. Zavala.

3. An affidavit executed by Mr. Zavala which states that he has never been arrested, tried or convicted of any criminal offense, whether it be in France, Switzerland, or anywhere else.

SBA, primarily based on the above-mentioned documents, determined that there is no evidence available at this time upon which an adverse character eligibility determination can be based, thereby precluding Mr. Zavala's association with the licensee.

RECOMMENDATION

Examination disclosed that the licensee's financial condition is unsound. As a result of such condition, the licensee has not paid its regular operating expenses for the past six months. Further, there appears to be little likelihood that the licensee's remaining investments will generate sufficient cash flow, if any, to keep the licensee solvent.

In addition, the licensee has indicated that it intends to use a substantial portion of SBA leverage to liquidate past due obligations, including all organizational costs, and to expand its office space.

Based on the above, it appears that funding of the licensee, at this time, would involve an extraordinary degree of risk coupled with limited potential benefit, if any, to the SBIC program.

Therefore, it is recommended that consideration be given to withholding SBA leverage, until the licensee has satisfactorily demonstrated to SBA that: (1) it is a viable business entity, and (2) sound management procedures and practices have been implemented.

EXHIBIT I

FINEVALOR CAPITAL CORPORATION

COMPARATIVE BALANCE SHEET

Assets	As of Dates 9/30/81	As of Dates 6/30/80
Loans and Investments		
Loans	$	$
Debt securities	1,009,940 2/	1,013,500
Equity interests		
Assets acquired in liquidation		
Operating concerns acquired		
Notes and other securities		
Unrealized appreciation (net of unrealized depreciation)	(341,000) 2/	
Total	$ 668,940	$ 1,013,500
Cash	189	(263)
Invested idle funds		
Receivable and accrued items (net)	90,077	
Other assets organization costs (net)	14,000	
Total Assets	$ 773,206	$ 1,013,237
Liabilities and Capital		
Notes and debentures payable to or guaranteed by SBA	$	$
Notes and debentures payable to others		
Accounts payable and accrued items	24,425	470
Deferred credits		
Other liabilities	435	
Due to officer	19,150	
Total Liabilities	$ 44,010	$ 470
Capital		
Capital stock and paid in surplus (net of Treasury)	$ 1,020,000	$ 1,014,650 1/
3% preferred stock (301(d) licensee's only)		
Unrealized gain (loss) on securities held		
Undistributed realized earnings	(290,804)	(1,883)
Total Capital	$ 729,196	$ 1,012,767
Total Liabilities and Capital	$ 773,206	$ 1,013,237

1/ Bank credit of $5,350 was not recorded in the licensee's books of account as of June 30, 1980.

2/ Includes two investments totalling $316,440, which are in the process of being written off.

SBA FORM 861 (8-76) REF SOP 90 35 PREVIOUS EDITIONS ARE OBSOLETE.

EXHIBIT 2

FINEVALOR CAPITAL CORPORATION

SCHEDULE OF OFFICERS AND DIRECTORS

September 30, 1981

Juan Zavala, president and chairman of the board

Dr. Jacob Mayer, vice president and director

Ricaldo Zavala, secretary, treasurer and director

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE INSPECTOR GENERAL

Date: JAN 22 1981

To: Raymond F. Randolph
AIG/A

From: Office of Inspector General AIG/I

Subject: Finevalor Capital Corporation

In response to your memorandum of October 21, 1980, requesting an investigative evaluation of the subject company, inquiries were made regarding the company's principal, Juan Zavala.

At our request, cables were sent by INTERPOL to several countries where Mr. Zavala had known antecedents. The significant information received from this source includes confirmation that Mr. Zavala has been also known as:

Juan Zavala Moreno
Israel Ion Zissu
Ion Zissu

At the present time Mr. Zavala is wanted in Switzerland for suspicion of fraud by means of checks issued in Zurich and Geneva in 1975.

Under the name of Juan Zavala Moreno, he was the subject of a 1980 investigation in Bern, Switzerland, for fraud involving the cashing of $30,000 in worthless checks drawn on the Toronto Dominion Bank, Canada.

Under the name of Ion Zissu, Zavala gave false information to the ABC Board, New York, New York, for application for a liquor license. He claimed he had $1,000,000 in a California bank which proved to be non-existent.

On March 13, 1970, a warrant for his arrest (which was subsequently cancelled) was issued in Salzburg, Austria, for fraud.

On April 19, 1967, he was sentenced in Paris, France, to 13 months' imprisonment, sentence suspended, and was fined 5000 francs for breach of trust and uttering worthless checks.

In 1958, he was the subject of an investigation by the Public Prosecutor's Office in Pfaeffikon, Switzerland, for attempted fraud.

On November 9, 1954, a warrant for his arrest was issued in Paris, France, for breach of trust and fraudulent bankruptcy.

Information obtained from U. S. Customs Service discloses Mr. Zavala was detained on September 8, 1978, and charged with failure to declare merchandise. The charge was mitigated and a penalty of $4,000 was assessed.

Information obtained from the Immigration and Naturalization Service indicated Mr. Zavala had two file numbers (since this inquiry these files have been combined). Mr. Zavala has recently requested a re-entry permit to travel outside of the United States; he also has an application pending for a resident visa. Mr. Zavala's wife is known as Sylvia Savala.

The Department of Justice, INTERPOL, has stated their file indicates Mr. Zavala, aka Israel Ion Zissu, also has criminal antecedents in Germany and Austria; however, no information has been furnished this office concerning the nature of these crimes or the disposition of the cases.

Inasmuch as Mr. Zavala is currently wanted in Switzerland for fraud and because of his prior arrest and conviction in France for fraud, we would recommend that you consider including in your Audit Report a recommendation that this SBIC license be revoked.

In view of the preceding information, we believe no further investigation is warranted and no further action will be taken by this office at this time.

R. R. Reusche
Assistant Inspector General
for Investigations

SBA

U.S. Small Business Administration
Office of Regulatory Audits,
Office of Inspector General

Report on Examination of

(SPECIAL REPORT)

FEYCA INVESTMENT COMPANY (04/04-5148)
CORAL GABLES, FLORIDA

A Small Business Investment Company

For Internal Use Only

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On May 14, 1982, an examination report was issued for Feyca Investment Company for the period ended January 31, 1982. The report revealed a regulatory matter relating to advances and salaries paid to Felipe De Diego, president and director of the licensee. The report indicated that De Diego received advances totaling $45,992 for the 12-month period ended June 30, 1981, and $78,658 for the seven month period ended July 31, 1982, in addition to his salary.

In its examination letter of June 23, 1982, SBA instructed De Diego to repay the $124,650.

The licensee responded with a letter dated July 7, 1982, from its recently retained certified public accountant, Roberto P. Perkins. Perkins said that De Diego had explained to him that the amounts recorded as advances to officers on the books of the licensee were erroneously classified as such by the prior accountant, Antonio C. Diaz.

Perkins stated further that the majority of these items represented expenditures for automobile expenses, travel on company business, purchase of automobiles by the corporation and other company related expenses that should not have been classified as advances to officer, but to their respective expense and asset accounts.

Perkins said the problem arose because De Diego did not notice how these charges were being classified at the time the June 30, 1981 audit was performed due to continuous travel and business requirements.

Perkins said the SBA Form 468 for the period ended March 31, 1982, reflected the reclassification of the advances to their proper accounts.

In view of these representations, the Investment Division requested a follow-up examination to determine the accuracy of Perkins' statements.

1

SUMMARY OF RESULTS

The follow-up examination disclosed that the amounts classified as advances or loans to officer in the records of Feyca Investment Company were mostly personal expenditures on behalf of Felipe De Diego, members of his family, his business associates and other persons and had no relationship to the licensee's legitimate business activity. The expenditures were in payment for personal travel, entertainment and personal obligations and items.

The expenditures were entered into Feyca's records as advances or loans to officer by Antonio C. Diaz, C.P.A. There were no actual loans. Diaz classified the expenditures as loans to avoid reporting them as operating expenses of Feyca.

A further analysis of all licensee disbursements from January 1980 through June 1982 revealed other licensee expenditures which had been classified as operating expenses but which were actually personal expenses of De Diego.

Expenditures on behalf of De Diego can be classified into two categories: those which De Diego admits are personal and those he claims have a business purpose but which are open to question. The types and amounts of these expenditures are as follows:

	1980	1981	1982	Total
Personal Expense Draws	$ 6,000.00	$ 6,600.00	$ 6,000.00	$ 18,600.00
Personal Travel	1,332.00	12,172.20	4,508.00	18,012.20
Personal Travel Expense Draws	1,500.00	5,600.00	200.00	7,300.00
Hotels and Motels	194.08	9,486.36	5,253.58	14,934.02
Entertainment	107.51	5,044.87	5,234.07	10,386.45
Automobiles	--	7,252.20	--	7,252.20
Automobile Expenses	1,400.66	3,199.31	--	4,599.97
Personal Loan Payments	--	10,126.53	--	10,126.53
Personal Non-portfolio Loans	--	11,700.00	1,500.00	13,200.00
Personal Insurance	--	3,212.00	--	3,212.00
Political Contributions	100.00	2,000.00	30.00	2,130.00
Memberships	150.00	615.00	150.00	915.00
Donations and Promotions	601.60	770.00	606.90	1,978.50
Yacht Expenses		329.00	2,998.00	3,327.00
Misc. Personal Expenses	2,548.32	6,611.60	6,959.75	16,119.67
	$13,934.17	$84,719.07	$33,440.30	$ 132,093.54

During the course of the examination, it was discovered that De Diego may have made a false statement regarding a prior criminal charge. In addition, unanswered questions were raised regarding De Diego's capital injection and certain portfolio financings

The results of the examination are included herein, in addition to a recommendation for action.

METHOD OF PAYMENT

Licensee expenditures were made by check and credit card.

Bank Accounts

During the years 1980 through 1982, the licensee had the following checking accounts:

Bank	Account Number
International Bank Miami, Florida	11-01-235261
Southeast First National Bank of Miami, Miami, Florida	014-140958
Popular Bank of Florida Hialeah, Florida	30-02856-6

Each of these checking accounts was used for disbursements on behalf of De Diego. To identify the source of the disbursements discussed in this report, each check number will have a letter adjacent to it to indicate the bank on which the check was drawn. For example, "I" will indicate International Bank, "S" will indicate Southeast First National Bank and "P" will indicate Popular Bank.

Credit Cards

American Express Card #3720-479599-21009 was acquired in the name of Feyca Investment Company. The initial membership was for Felipe De Diego. A membership was later acquired for Coralia De Diego, De Diego's wife. American Express billings are for the period from December 1980 through July 1982 (Exhibit 1).

The total charges to American Express were as follows:

1980	1981	1982	Total
$367.79	$26,067.45	$25,929.15	$52,364.39

Diaz classified most American Express payments as loans to officer in the records of Feyca. In supporting documents to his letter of July 7, 1982, Perkins indicated the payments should be reclassified as promotion expenses. The nature of specific charges to American Express are discussed under the topics of Travel, Entertainment and Miscellaneous Expenditures.

Texaco credit card #1497200590 was acquired in the name of Feyca Investment Company. The charges to the card from May 1980 through June 1982 were as follows:

1980	1981	1982	Total
$2,551.14	$5,432.51	$2,261.52	$10,245.17

These charges were classified as loans or advances by Diaz and reclassified as auto expenses by Perkins. Texaco charges are discussed in detail under Auto Expense.

SALARY AND OTHER COMPENSATION

According to an employment agreement (Exhibit 2) between Feyca and De Diego, dated July 5, 1978, De Diego was hired for a period of five years, commencing with the licensing of Feyca. Feyca was licensed August 30, 1979.

The agreement provided for the following annual salary to be paid to De Diego:

1st Year	$18,000
2nd Year	$26,000
3rd Year	$34,000
4th Year	$42,000
5th Year	$50,000

The yearly increases in salary were contingent upon the corporation having gross profits equivalent to at least 9% of the amount of its capital yearly.

In addition, the agreement provided for a personal expense account for De Diego payable up to a limit of $500.per month. Any other expenses incurred by De Diego while fostering the corporation's businesses are subject to approval by the board.

De Diego received his annual salary as follows:

Period	Gross Salary	Net Salary
01-80 to 12-80	$20,781.93 (1)	$15,735.16
01-81 to 12-81	29,166.68 (2)(3)	20,624.44
01-81 to 05-31	14,166.65	9,879.05
Totals	$65,115.26	$46,238.65

(1) De Diego received a September 1980 salary increase to $2,833.33 monthly, or $26,000 annually.

(2) Increase in salary in September 1981 to $34,000 annually.

(3) Includes Christmas bonus of $500.

De Diego drew the following amounts as compensation for personal expenses:

Period	Amount
01-80 to 12-80	$6,000
01-81 to 12-81	$6,600
01-82 to 05-31	$6,000
Total	$18,600

During 1980 and 1981, these amounts were drawn more or less on a monthly basis in amounts of $500, with the exception of February 1981 when $600 was drawn. In 1982, De Diego began to draw $1,000 a month. There is no indication this increase was approved by the board of directors. The checks or check stubs for these draws bear the notation "personal expenses;" and, are classified in the licensee's books as expenses.

De Diego made no accounting to the licensee as to how the money was spent. De Diego has no records to substantiate the expenditure of these monies.

Also, De Diego drew amounts from the licensee for travel expenses. These draws are discussed below under Travel.

TRAVEL

Airfare

During the years 1980, 1981 and 1982, De Diego made a substantial number of business and personal trips which were paid for by the licensee. Payment for airfare was made by check to a travel agency or charged to the licensee's American Express card. The licensee paid for airfare for not only De Diego but also members of his family, business associates and other persons.

The licensee's records included some invoices from Biltmore Travel Agency (Biltmore). Additional duplicate invoices were obtained from Biltmore. De Diego reviewed available invoices and American Express billings and identified personal travel. De Diego's recollection is the source for his identification as he has no records to show the purpose of each trip.

De Diego's identification of personal travel paid by check to Biltmore and Trias Travel Agency is contained in Exhibit 3 of this report. Personal travel charged to American Express is contained in Exhibit 4. Supporting invoices from Biltmore and Trias for personal travel are to be found in Exhibit 5.

In the exhibits De Diego refers to Felipe De Diego. Mr. & Mrs. refers to Mr. & Mrs. De Diego. Palma, Garcia and Pena refers respectively, to Gabriel Palma, Ramon Garcia, and Ovidio A. Pena, business associates of De Diego. Carmen Gonzalez and Carmen Llanes are persons whose exact relationship with De Diego are unknown.

In addition to travel for pleasure, De Diego made a substantial number of trips to Venezuela and New York City. De Diego said his visits to New York would be to meet with Gabriel Palma, a business representative or public relations person who got De Diego deals in other cities (Exhibit 6, page 11). With the exception of a participation with other MESBICs in financings to Jana Broadcasting, all of Feyca's SBCs are in the Miami area. Apparently, the assistance Palma provided De Diego does not involve licensee financings.

The purpose of De Diego's Venezuelan trip are to arrange private business deals with Venezuelan nationals (Exhibit 6, pages 9, 20, 25-27).

One trip which Mr. and Mrs. De Diego took to Los Angeles in 1981, was to attend a Republican national convention.

De Diego identified certain payments to Biltmore and certain American Express charges as being for business travel. Payments to Biltmore for those trips classified as business are shown in Exhibit 7. American Express charges for travel classified as business are shown in Exhibit 8. Supporting invoices from Biltmore for business travel are in Exhibit 9.

Although De Diego identified certain trips as business travel on behalf of the licensee, some items are questionable. For example, with only one exception, the licensee's financings are to firms in the greater Miami area. The one exception is located in Chicago, with a subsidiary in Galveston, Texas. Legitimate travel on licensee business should be to Chicago and/or Galveston, to Washington to consult with SBA officials and to Los Angeles to attend the MESBIC Convention held there in 1981. Side trips to New York and San Francisco are not relevant to the licensee's business.

In addition, neither Gabriel Palma or Mrs. De Diego was an officer, director, employee or paid consultant to the licensee. Accordingly, travel for Palma and Mrs. De Diego is not relevant to the licensee's business.

Although De Diego identified certain American Express billings as relating to Feyca business, it is difficult to assess the validity of these charges due to the sketchy information provided with the billings.

Personal travel paid by check and charged to American Express was $16,735.40. Business travel was $9,256.14.

Amtrak and Gray Line

De Diego charged Amtrak and Gray Line tour tickets to American Express. He identified the Amtrak fare as relating to Feyca business. However, as these are side-trips to New York for personal business they should not have been incurred by Feyca. The Gray Line tour was identified as personal.

Billing Date	Carrier	Amount	Destination
10-30-81	Amtrak	$32	Washington to New York
10-30-81	Gray Line	$57.80	Los Angeles
05-28-82	Amtrak	$52.00	Washington to New York
05-28-82	Amtrak	$136.00	Washington to New York
	Total	$277.80	

Travel Expense Draws

As mentioned above, De Diego drew amounts from the licensee by check to defray travel costs. These amounts are listed in Exhibit 10 according to De Diego's classification of the trip as business or personal.

Total draws for business and personal travel were:

	1980	1981	1982	Total
Business	$7,318	$4,000	$600	$11,918
Personal	1,500	5,600	200	7,300
Total	$8,818	$9,600	$800	$19,218

De Diego kept no records of how the money was spent and made no accounting to the licensee for the use of the monies. De Diego did prepare receipts for some of the advances (Exhibit 11). Some receipts show the purpose of the advance.

Despite drawing these amounts to defray travel costs, De Diego also charged meals and hotels to the licensee. These charges and payments are discussed under Hotel and Motels and Entertainment.

There is no indication the travel expense draws were approved by the board as required by De Diego's employment agreement. Initially, Diaz classified these draws as expenses but later began to show them as advances or loans to officer. Perkins reclassified them as travel expenses.

Hotels and Motels

In addition to the amounts drawn for travel expenses, lodging was charged to the licensee's American Express card and ultimately paid for by the licensee. De Diego reviewed the American Express billings and classified the charges as personal or business. These charges are listed in Exhibit 12 of this report.

Total U.S. hotel and motel charges to American Express by year were as follows:

	1980	1981	1982	Total
Business	$ -	$3,274.84	$1,565.67	$4,840.51
Personal	$194.08	1,793.15	1,287.75	3,274.98
Total	$194.08	$5,067.99	$2,853.42	$8,115.49

Charges to American Express for hotel accommodations and restaurants in Venezuela have been conceded by De Diego as personal. These billings are shown in Exhibit 13. The totals by year are:

1980	1981	1982	Total
-0-	$7,693.21	$3,965.83	$11,659.04

In addition to the above American Express charges, the licensee made payment of $817.06 by check 301S to the Hyatt Regency, Chicago, in June 1980.

De Diego has no records to substantiate the business aspect of lodging charges. There is no indication these charges and payments were approved by the board of directors.

ENTERTAINMENT

De Diego charged a large number of restaurant and nightclub bills to the licensee's American Express card. These charges were ultimately paid by the licensee. The number of separate billings for restaurant and entertainment charges with the total dollar amount of these expenditures are shown below. A complete listing by recipient is shown in Exhibit 14.

Period	Total Billings	Total Amount
1980	3	$ 107.51
1981	174	5,044.87
1982	166	5,234.07
		$ 10,386.45

De Diego classified these charges as all relating to business. However, De Diego has no records to substantiate the business purpose of these charges and no recollection as to who was present at the time these charges were made.

OTHER EXPENDITURES AND TRANSACTIONS

AUTOMOBILES

On December 12, 1979, De Diego contracted with Biltmore Rent-A-Car, Inc. to lease a 1980 Cadillac Coupe De Ville. The lease term was for 24 months with 32,000 free miles and $.05 for each additional mile. The monthly lease payment was $398.94. The lease was in the name of Feyca.

De Diego said that-the 1980 Cadillac was returned to Biltmore Rent-A-Car, Inc. when the lease expired. However, check 839 S dated January 8, 1982, is payable to Biltmore Rent-A-Car in the amount of $23.38; the check bears the notation "transfer of '80 Cadillac." Due to the limited time authorized, an opportunity to verify the disposition of this vehicle was not available.

In May 1981, De Diego purchased a 1979 Chevrolet Corvette from Biltmore Rent-A-Car, Inc. for $8,852.28 in licensee funds. This vehicle was on a lease agreement in the name of De Diego's wife, Coralia, and was being driven by their son, Felipe A. De Diego. According to De Diego, the lease payments were paid by his wife until the purchase by the licensee. De Diego said the vehicle was placed in the name of the licensee.

Diaz classified this payment as advance to officer. The vehicle did not appear on the SBA Form 468 for June 30, 1981.

In November 1981, De Diego purchased a 1981 Ford Fairmont stationwagon with licensee funds. This vehicle was placed in the name of Coralia De Diego. The total cash price was $7,252.20. The vehicle was purchased from Ford Midway Mall, Miami.

In December 1981, De Diego purchased a 1982 Cadillac in the name of the licensee. The vehicle was purchased from George Williamson Cadillac, Miami. According to documents from Williamson, the transaction was as follows:

Cash Price	$25,018.24
Title and License	77.40
Down Payment	5,065 49
Amount Financed	$20,030.15

However, disbursements to Williamson were check 1491, dated 9-27-81 for $1,000 and check 1791, dated 11-06-81, for $4,565.49; or, $5,565.49. The $500 difference is unexplained and time wasn't available to reconcile the matter.

The vehicle is financed at First National Bank of South Miami, with payments of $560.64 monthly.

In January 1982, the Corvette was traded-in on a 1981 De Lorean at Braman Motors, Miami. According to documents in the licensee's files, the

De Lorean cost $27,658.91. However, De Diego said the vehicle only cost about $13,000.

De Diego said they were allowed a $11,000 trade-in for the Corvette which they purchased for $8,852.28. The difference was paid for with check 1971, dated 01-19-82, in the amount of $5,000.

The difference between the apparent purchase price and the amount De Diego said was paid has not been reconciled due to time constraints.

According to De Diego, the De Lorean was placed in the name of the licensee.

Automobile Expenses

Most automobile expenses are related to purchases of gasoline, tires, etc. by use of the licensee's Texaco credit card. As previously stated, total Texaco charges were $10,245.17.

The Texaco credit card was used by De Diego, his son, Felipe A. De Diego, and his wife, Coralia De Diego. An analysis of Texaco charges during 1980 and 1981, revealed the following amounts charged by the above-named individuals:

	De Diego	Felipe A. De Diego	Coralia De Diego
1980	$1,130	$1,085.45	$315.21
1981	2,201.07	2,709.89	489.42
	$3,331.07	$3,795.34	$804.63

As shown, more charges were incurred by De Diego's son and wife than De Diego himself. De Diego said that sometimes his son had to go collect some money and would use the Texaco card for gas. However, Felipe A. De Diego did not receive his first paycheck from the licensee until March 19, 1981, and did not become an officer of the licensee until March 1982. Coralia De Diego has never been an officer or employee of the licensee.

With the exception of one charge, all charges were made at gas stations in

Miami. And, substantial purchases were made for vehicles not belonging to Feyca; charges were made for the Corvette, prior to the time it was acquired by the licensee, for a Jeep and a Pontiac, and other unidentified vehicles.

In addition, $5,279.69 was paid for auto repairs, paint and body work, tires and seat covers, during the period 1980-1982. De Diego does not have invoices or other receipts to show the vehicles which incurred these charges.

Loan Payments

Check 744S, dated 09-25-81, for $2,147.01 and check 745S, dated 09-25-81, for $2,142.01 were paid to Intercontinental Bank to partially liquidate loan #11-38-05236-5. De Diego identified this loan as a personal liability.

Check 747S, dated 09-25-81, in the amount of $837.51, was paid to Intercontinental Bank. The check bears the notation "Interest Systems Builders."

Systems Builders Corporation is a business operated by De Diego's son, Miguel De Diego, an architect. According to the SBA Form 468 for the period June 30, 1981, the licensee was contingently liable to a bank as guarantor of notes for $55,000 from Systems Builders.

Although De Diego signed the Form 468 containing this statement, he denies that the licensee guaranteed any notes for Systems Builders. In addition, he denies that check 747S was in payment of any interest for Systems Builders; but he cannot explain the purpose of the check even though he signed it.

Checks 239I and 240I, dated 06-18-82, in the amounts of $2,000 and $3,000 respectively, were paid to Coralia De Diego. De Diego said that because the licensee was short of cash, he borrowed $15,000 from his wife. De Diego said the loan had since been repaid. In addition to the above payments, payments of $7,000 and $3,000 were made. There is apparently no note evidencing this indebtedness.

Non-Portfolio Loans

De Diego issued the following checks to Ramon Garcia:

Check	Date	Amount
1421	09-02-81	$3,000
737S	09-18-81	3,000
1601	10-15-81	1,000
1801	12-10-81	3,000
1921	01-11-82	1,500
		$11,500

De Diego said $8,500 was for a personal business deal between Garcia and himself. The purpose of the deal was to cover a parking lot adjacent to the licensee's office. De Diego said the deal fell through when the building owner did not approve of the plan.

De Diego said Garcia subsequently repaid the $8,500; but he did not state the $3,000 was also repaid. There is apparently no note evidencing this transaction.

Diaz classified these amounts as advances or loans to officer. Perkins reclassified them as "Other" expense.

Garcia is a principal of Adama Corporation, an SBC financed by Feyca.

In March 1981, De Diego advanced $2,000 by check 565S to Jennifer Martin, also known as Migdalia Sanchez, an employee of Feyca. The purpose of the advance was to enable Martin to purchase a car.

The advance was to be liquidated at the rate of $85.00 a month. However, Martin terminated her employment with Feyca.

De Diego did not obtain a note for the transaction, only an agreement (Exhibit 15). And, he did not perfect a security interest in the vehicle. As a result, Martin still has the car and the licensee wrote off the balance of the advances, $1,700.

Use of licensee funds for personal business deals and loans to employees is unacceptable and inappropriate behavior for an officer of the licensee.

Insurance

In 1982, the licensee purchased automobile insurance from Bentley Insurance Company for the De Lorean and the 1982 Cadillac El Dorado. The costs were $1,915 and $1,765, respectively.

In addition, the licensee paid for insurance from Bentley on De Diego's personal assets. Check 215I, dated 04-23-8, in the amount of $2,438 paid for coverage on De Diego's yacht, the Ivonne (named for his daughter, Ivonne De Diego Ruiz). Checks 216I and 217I, both dated 04-23-82, in the amounts of $292 and $482, respectively, paid for insurance on the 1981 Ford and a 1974 Jeep.

Diaz classified the payments for coverage on the De Lorean, the yacht and the Ford as advances to officer. Perkins did not deal with these expenditures as they were subsequent to 12-31-81.

Political Contributions

The licensee made the following political contributions:

Check	1980 Payee	Amount
398S	GOP Victory Fund	$100
	1981	
544S	GOP Victory Fund	$1,000
620S	Republican National Committee	150
789S	Republican National Committee	500
790S	Republican National Committee	50
776S	Luis Morse Campaign Fund	300
	1982	
964S	Moral Majority	30
	Total	$2,130

In addition, Mr. and Mrs. De Diego attended a Republican National Convention in 1981 at licensee expense.

Diaz classified these political contributions as operating expenses of Feyca.

Political contributions by a Federal licensee would seem inappropriate and are not connected to licensee's business.

Memberships

The following memberships were paid for with licensee funds and classified as operating expenses of Feyca:

Check	Payee	Amount
	1980	
316S	Bayshore Partnership-Gym	$150
	1981	
559S	Eastern Ionosphere Club	100
597S	Playboy Club	15-
778S	Pan Am Clipper Club- Lifetime Membership	500
	1982	
976S	Eastern Ionosphere Club	100
999S	Discover Americard	30
940S	Playboy Club	20
		$915

While such memberships may have personal benefit for De Diego, they are not connected with the licensee's business.

Donations

The licensee made the following donations, which were classified as operating expenses:

Check	Payee	Amount
	1980	
158S	Dade Police Benevolent Assoc.	$ 35
163S	Mailhandlers' Dance	18
202S	Loyola School	10
380S	Dade Police Benevolent Assoc.	50
427S	Dade Police Benevolent Assoc.	35
	1981	
504S	Dade Police Benevolent Assoc.	240
554S	Mailhandlers' Dance	18
581S	Nat'l Assoc. of Lettercarriers	25
594S	Friends of Fraternal Order of Police	10
610S	Arabesque Ballet	75
694S	Variety Children's Hospital	25
772S	Christopher Columbus High School	45
794S	Variety Children's Hospital	25
	1982	
947I	Police Athletic League	25
947S	Police Barbeque	25
		$661

It would seem more appropriate for an individual to make these donations rather than the licensee.

Promotions

The licensee paid the following amounts for flowers:

	1980	1980	1982	Total
La Dalia Flower	$249.60	$307	$397.90	$954.50
Floridondeus Flower	204	-		204
SaBoridoflowers	-	-	159	159
Totals	$453.50	$307	$556.90	$1,317.50

De Diego said that when someone dies, or there is a wedding, or a child is born, he sends flowers. Since it is his business card from Feyca which he sends with the flowers, he considers this a promotion for Feyca.

These expenditures were classified as operating expenses.

According to licensee records, a $75,000 commitment has been made to La Dalia Flower Shop.

Yacht Expense

In the latter part of 1981 or 1982, De Diego acquired the yacht "Our Way" and changed its name to "Ivonne." Using licensee funds, De Diego paid for a substantial amount of expenses relating to the acquisition and maintenance of this vessel:

Date	Check	Amount	Payee	Purpose
12-15-81	818S	$329	Surveying Trading Corp.	Appraisal
01-15-82	854S	435	Sharon Chadwick	Vessel documentation
01-22-82	862S	490.36	Marina Biscayne, Inc.	Dockage
02-02-82	876S	388.85	Marina Biscayne, Inc.	Dockage
03-05-82	905S	370.76	Marina Biscayne, Inc.	Dockage
03-25-82	922S	319.60	Marina Biscayne, Inc.	Dockage
03-26-82	923S	200	Marina Biscayne, Inc.	miscellaneous
04-05-82	934S	370.76	Marina Biscayne, Inc.	Dockage

Date	Check	Amount	Payee	Purpose
04-23-62	952S	$25	Marine telephone	Telephone
	967S	374.47	Marina Biscayne	Dockage
	990S	23.20	American Marine	Supplies
Total		$3,327.00		

Diaz classified these amounts as advances. Perkins classified the payment to Surveying Trading as an "Other" expense; but, did not deal with the other expenditures.

These are obviously personal expenses of De Diego.

Office Space

The licensee occupies an office in the Almeria Professional Building on which it pays rent of $728 a month. Approximately one-quarter of this space is occupied by Systems Builders Corporation, a company belonging to De Diego's son, Miguel De Diego.

De Diego said he had an office made and enclosed for his son in the licensee's office to help him out. The situation is just temporary according to De Diego. His son pays no rent for use of the office and his telephone is answered by the licensee's secretary.

During the period from 1980-1982, the licensee spent over $8,000 for lumber, tile work, ornamental iron, carpentry and electrical work, paint, concrete, ornamental rock and other building supplies. According to De Diego, this was for leasehold improvements, including the office for his son.

Miscellaneous Expenditures

The licensee paid for a number of items for De Diego that can only be regarded as personal. These purchases were paid by check and charged to American Express.

Examples of items paid by check include $1,465 for real estate data connected to his son's business; $656.16 for a 9 mm Browning Automatic pistol; $2,500 for a security alarm system in his residence; and, $572 for carpet. A list of these expenditures is in Exhibit 16.

De Diego reviewed American Express billings paid for by the licensee and identified personal expenditures. Total personal items charged to American Express were $4,033.60 in 1981 and $5,577.79 in 1982.

These charges included $769.54 for liquor, $220.95-for an exercise bike; $2,402.92 for clothing, $1,104.65 for jewelry; $2,704.20 for eight place settings; and, $627.97 for marine supplies. Complete listings of these charges are in Exhibits 17 and 18.

ACCOUNTANTS' EXPLANATION

Diaz said the reason that he classified expenditures as advances or loans to officer was because he felt Feyca did not need the expenses and could not justify them (Exhibit 19). Diaz felt they were personal expenses of De Diego and were not operating expenses of Feyca.

Diaz suggested to De Diego on several occasions that he increase his salary and pay for these expenses himself.

Diaz classified the expenditures as advances to avoid overstating operating expenses.

Diaz said that he and De Diego had discussed these type of expenses many times and had just disagreed about whether they were for Feyca or were personal.

In a letter to SBA, dated July 7, 1982, the licensee's new accountant, Roberto P. Perkins, discussed the items classified as advances (Exhibit 20). Perkins said that De Diego had explained to him that the amounts recorded as advances to officers on the books of the licensee were erroneously classified as such by the prior accountant, Diaz.

Perkins stated further that the majority of these items represented expenditures for automobile expenses, travel on company business, purchase of automobiles by the corporation and other company related expenses that should not have been classified as advances to officer, but to their respective expense and asset accounts.

Perkins said the problem arose because De Diego did not notice how these charges were being classified at the time the June 30, 1981 audit was performed due to continuous travel and business requirements.

Perkins said the SBA Form 468 for the period ended March 31, 1982, reflected the reclassification of the advances to their proper accounts.

In a personal interview, Perkins gave his assurances that this problem would not happen again (Exhibit 21).

DE DIEGO'S EXPLANATIONS

De Diego said there were no loans to him. The C.P.A. misclassified expenses as loans. De Diego did not know it until the inspector, Ratliff, came and told him about it. De Diego said Ratliff told him to fire that C.P.A and hire another.

De Diego said another part of the problem was that he had trouble keeping himself and Feyca apart in his mind. He put in his money and bought the stock and was the major stockholder. In his mind, he and Feyca are the same. So, it was difficult to separate what was personal and what was on behalf of Feyca.

De Diego said he now knows he was doing wrong. This has been explained to him. From now on he will keep the accounts clean.

Additional statements by De Diego are to be found in Exhibits 6, 19 and 22.

OTHER MATTERS

Licensee Financial Status

The most recent full-year Form 468 available is that for the period ended June 30, 1981. Gross revenues for that period were $120,412 and operating expenses, less non-cash charges, such as bad debt reserve and depreciation were $118,686. Operating expenses do not include expenditures of $45,992 classified as advances to officer. Therefore, the licensee had a net operating profit of $1,726 for the period.

A trial balance for the seven-month period ended January 31, 1982, showed gross revenues of $116,906 and operating expenses, less non-cash charges, of $97,213; or a net operating profit of $19,693.25 for the period. This did not include additional expenditures of $78,658 for the period which were classified as advances.

As of March 31, 1982, the licensee's portfolio at cost was $1,651,952 with unrealized depreciation of $82,598, or, a net valuation of $1,569,354. The licensee's portfolio consists solely of loans and debt securities.

The Form 468 for the period ended June 30, 1981, showed accrued interest on loans receivable of $70,358, with $47,747 of that-amount delinquent. Although subsequent Form 468s for December 31, 1981, and March 31, 1982, show no delinquency, De Diego stated he does have delinquency and collection problems with the licensee's portfolio.

Most of the licensee's financings are uncollateralized; if collateral exists, it is generally subordinated.

As of March 31, 1982, idle funds were $129,209, although some financings have been made since then. As of the same date, the licensee anticipated current maturities of $289,970 from its portfolio.

In January 1982, the licensee borrowed $22,000 from Intercontinental Bank but this amount has been repaid; and, De Diego said the $15,000 borrowed from his wife has been repaid. With the exception of the amount owed on the 1982 Cadillac and accounts payable, SBA is the only creditor.

SBA has debentures of $1,000,000, all with maturities in 1991. SBA is a preferred stockholder with $500,000 invested. No dividends have been paid on this stock.

The time necessary to make inquiry into the true status of the licensee's portfolio and financial condition was not available. As a result, it is difficult to assess SBA's exposure and risk as the major creditor of the licensee.

Personal Background

On March 7, 1974, De Diego was indicted for conspiring to violate the civil rights of Dr. Lewis Fielding. This indictment arose as a result of De Diego's participation in the burglary of Dr. Fielding's office on September 1, 1971. At that time, De Diego was a recruited member of the White House Special Investigations Unit, known as the "Plumbers."

Fielding was the psychiatrist of Daniel Ellsberg, who made public the so-called "Pentagon Papers." The purpose of the burglary was, apparently, to obtain incriminating information regarding Ellsberg.

After indictment, the charges against De Diego were initially dismissed because the evidence used against him would be based upon immunized testimony he had given a Florida prosecutor. In April 1975, after the government appealed, the indictment was subsequently dismissed the same year at the request of the Watergate special prosecutor.

In addition, De Diego has admitted to burglarizing the Watergate Office of the Democratic National Committee on two occasions. De Diego was not present on June 17, 1972, the day of the infamous Watergate break-in, because it was the day of his daughter's wedding.

In his statement of personal history, SBA Form 415A (Exhibit 23), De Diego responded in the negative to Question 10 which asked if he had ever been charged with any criminal offense. His response does not appear to be true.

While this matter may have no direct bearing on the issues at hand, it does raise some questions regarding loans which the licensee has made to two concerns involving individuals who were arrested, indicted and subsequently sentenced for their part in the Watergate break-in. These individuals are Frank Sturgis and Virgilio Gonzalez.

Portfolio Concerns

Frank Sturgis is secretary-treasurer, director and 50% shareholder of Hunt-Sturgis Enterprises, Inc., d/b/a King Video, a retailer of video tape recorders. Jan Sturgis is president, director and 50% shareholder.
In September 1980, Hunt-Sturgis received the first disbursement of a $60,000 loan from the licensee. The purpose of the loan was to buy inventory and for working capital.

According to the licensee's eligibility profile, Hunt-Sturgis qualified for financing from the licensee because Frank and/or Jan Sturgis was of Italian descent and unable to obtain bank financing.

Virgilio Gonzalez is secretary, director and one-third owner of Vice Corporation (VICE), a retail discount store. The other principals are Celia Gonzalez, president, director and one-third shareholder, and Gleano Franco, treasurer, director and one-third shareholder.

In November 1979, VICE received the first disbursement of $50,000 loan. VICE subsequently received an additional $104,500 in loans. According to the Form 468 for June 30, 1981, VICE had an outstanding balance of accrued interest payable of $11,130, of which $10,050 was delinquent. Despite the delinquency, VICE received an additional $100,000 in March 1982.

The questions which these two loans to start up businesses raise are whether these are arms-length transactions and to what extent special consideration was given Sturgis and Gonzalez because of their prior relationship with De Diego.

De Diego's relationship with other SBC principals and concerns is also of interest.

As previously stated, De Diego gave $11,500 in licensee funds to Ramon Garcia for a private business deal. Garcia was a frequent traveler to Caracas at licensee expense, also apparently for private business deals.

According to licensee records, Garcia is 100% shareholder of Adama Corporation, a start-up manufacturer of fishing boats financed by the licensee. Adama has received $153,100 in licensee funds. According to the 468 for June 30, 1981, Adama owed the licensee $6,893 in interest, of which $1,875 was delinquent.

In March 1980, Garcia responded to a confirmation regarding the financing initiated by the Office of Regulatory Audit. The confirmation was sent to Adama at the address contained in the licensee's records - 11610 Southwest 32nd Lane, Miami.

However, a visit to that address by a representative of Dun and Bradstreet revealed that the building at that address was the residence of Antonio Fajargo and not the offices of Adama Corporation. Further, Adama Corporation's name was unknown to local authorities and directories.

Checks 562S, 584S and 625S each in the amount of $500 and dated 03-11-81, 04-02-81 and 05-07-81, respectively, are payable to Carmen Gonzalez. Checks 562S and 584S bear the notation "FEE-CREDIT ANALYST."

Gonzalez is 100% shareholder of Prestige of Westland, Inc., a boutique. In July 1981, Prestige received the first disbursement of a $105,000 financing.

When asked the nature of the above payments to Gonzalez, De Diego stated she was hired to work on the licensee's books. This was at the same time the licensee was paying $200 a month to Diaz for keeping the licensee's books.

When questioned regarding a trip to Washington, D. C. by Gonzalez which was paid for by the licensee, De Diego classified the trip as personal.

Private Capital

Upon licensing in August 1979, the initial capitalization of the licensee was $310,000. De Diego was 5% shareholder with five shares purchased for $3,100 a share, or $15,500. In July 1980, De Diego purchased an additional 20 shares from existing shareholders. The purchase price of these shares is unknown, as is the method of purchase.

In December 1980, the licensee increased its capital to $511,500. This increase was accomplished through the purchase of 65 shares of newly issued stock by De Diego for $201,500. This stock was placed in the name of the De Diego family trust. In March 1982, the trust acquired an additional five shares from a resigning shareholder. The purchase price and method of purchase of this stock is unknown.

In a letter dated January 7, 1981, De Diego advised SBA that the $201,500 stock purchase was accomplished by borrowing $100,000 from a private investor, $60,000 from a bank and $41,500 from personal resources. The following deposits relating to the stock purchase were made to the Feyca account at Popular Bank on the following dates:

	12-05-80	12-17-80
Currency	$ 10,090	$ 9,000
Checks:	90,000	10,000
	59,910	9,000
	5,000	8,500
Totals	$165,000	$ 36,500

De Diego stated that the $100,000 was borrowed from Jose Cabal Passapera, a Venezuelan national; and, that the $60,000 was borrowed from Popular Bank. To show that his networth was twice the amount borrowed, De Diego provided a personal financial statement to SBA dated December 31, 1980 (Exhibit 24), showing a net worth of $323,000.

In the financial statement, De Diego indicated total liabilities of $241,000, which included $74,000 in deferred taxes; or, net liabilities of $167,000. The net liabilities consisted of a $100,000 note payable and $67,000 owed as mortgages on his home.

De Diego subsequently explained in a letter dated February 6, 1981, that the $67,000 consisted of a first mortgage of $22,000 and a second mortgage of $45,000 to Popular Bank. The second mortgage to Popular was originally in the amount of $60,000 and was the source of a portion of the funds used to increase the licensee's capital.

In other words, from the time the funds were deposited in early December until December 31, De Diego has already reduced his loan liability by $15,000. However, this conflicts with a letter written by Orlando Baro, Popular's president, and dated January 7, 1981 (Exhibit 25). In the letter, Baro indicated that the $60,000 had just been approved and on terms different than those described by De Diego on his financial statement.

At the time of the follow-up examination in August 1982, De Diego stated the $60,000 loan from Popular had been paid off and the loan from Cabal had been reduced to about $50,000.

The financial statement dated December 31, 1980 showed no liability for the 20 shares of licensee stock De Diego acquired in July 1980. This stock, assuming it was purchased for $3,100 a share, had a cost of $63,000.

Thus, between July 1980 and August 1982, De Diego had acquired stock and reduced loan liabilities for a total of $193,000.

Potential Tax Consequences

The licensee reported a loss of $34,761 for the period ended June 30, 1981. After correction of those personal expenses previously deducted as operating expenses, it is possible that the licensee would have a small income tax liability for that fiscal year.

Inasmuch as the Form 468 for the period ended June 30, 1982 has not yet been filed, it is difficult to approximate the licensee's income tax liability for that period.

To the extent that the licensee has profits for these periods, De Diego would have personal tax liabilities from the expenditures which were made on his behalf. These expenditures would be taxed to him as dividends.

However, it is not possible to calculate his potential liability due to inadequate information.

CONCLUSIVE COMMENTS

The follow-up examination raises as many questions as it answers regarding the operations of Feyca Investment Company. However, to a certain degree, conclusions can be formed regarding the use of licensee funds by Felipe De Diego.

An analysis of licensee disbursements during 1980-1982, shows that De Diego has maintained an extravagant lifestyle at the licensee's expense. So pervasive are these personal expenditures that they extend from automobiles and personal loan payments to parking tickets and flowers.

And, De Diego was quite willing for these personal expenditures to be borne by the licensee under the guise of legitimate licensee expenses. In July 1982, De Diego hand-delivered a letter from his new accountant, Robert P. Perkins, to SBA. The letter gave De Diego's explanation that those amounts classified as advances were actually expenses of Feyca and were so erroneously classified by the prior accountant. A listing showing the amounts re-classified as expenses was included with the letter.

De Diego had to be aware of the contents of the letter as he delivered it. Obviously, he was willing for SBA to accept his explanation and resolve the matter in his favor.

Upon being questioned at the time of the follow-up examination, he did an about face and admitted that a substantial amount of the expenditures were personal. However, he attempted to qualify this by claiming a good faith misunderstanding as to the business nature of certain expenditures.

First, he stated he had difficulty differentiating between Feyca and himself because he was the major stockholder; in his mind, he and Feyca were the same. So, it was difficult to separate what was personal and what was on behalf of Feyca.

Second, regarding his trips to Venezuela, De Diego claimed a sudden awakening that the trips resulted in personal benefit for him and were not connected with the licensee's business.

If his statements reflect his true state of mind on these matters, he is incredibly unsophisticated - too unsophisticated to operate the licensee; more likely, it is posturing to mitigate the magnitude of the expenditures.

Further, De Diego has attempted to appear ingenious by claiming ignorance. De Diego said he was not aware that expenditures had been classified as advances or loans to officer until told of their existence by James Ratliff, the SBA examiner.

However, Diaz stated that he and De Diego had discussed the matter on several occasions during the time Diaz was keeping the licensee's books. And, the SBA Forms 468 which were submitted for the periods June 30, 1981 and December 31, 1981 show loans to officer on their balance sheets. De Diego signed these forms.

The exit conference between De Diego and Ratliff took place April 7, 1982. If this was the first time De Diego became aware of the advances classifications, it apparently did not trouble him too much as he continued to charge personal expenses to the licensee subsequent to that date.

De Diego even intimated that it was Ratliff who told him to fire Diaz. Ratliff denies this and said that Diaz had already been replaced as the licensee's C.P.A. at the time of the conference.

Despite his initial protestations of confusion regarding personal and business expenses, De Diego later made some telling comments regarding the expenditures.

De Diego said he had to have some floor like the paid expenses or it was not worth it to him. He could do better at a savings and loan. De Diego said it was his own money and he was using it to promote business to keep alive; and, that costs money.

These sentiments seem to more accurately reflect De Diego's intent with regard to the personal expenditures. He initiated and signed the checks; he made the charges to American Express; he signed the Forms 468; and, he had the conversations with Diaz. He knew that his personal expenses were being paid by the licensee.

To conceal this, De Diego made false representations to SBA intending that they be acted upon. He allowed false entries to be made in the licensee's books and records and the Form 468 for March 31, 1982. He has continued the pretense by insinuating that his substantial travel and entertainment expenses actually had some relationship to the licensee's business.

The actual truth of the matter is that De Diego has conducted a surreptitious raid upon the licensee's earnings and capital to promote personal business ventures.

The remedy which De Diego proposes to resolve this situation is that he be allowed to repay the licensee any amounts determined to be his personal expenses. De Diego said all the money would come back to him anyway if he repaid it to Feyca, since he was the major stockholder.

This hardly seems a resolution. De Diego would still control the licensee's activities. He would still initiate and sign checks, which would be co-signed by his 23 year old son. He would be unsupervised by a board of directors. This would be tantamount to allowing the fox to guard the chicken coop.

And, as mentioned, there are still troublesome aspects of certain financings and the licensee's private capital.

De Diego has jeopardized the program by the loans he has made to Frank Sturgis and Virglio Gonzalez. He has risked substantial adverse publicity for the licensee and SBA. While Sturgis and Gonzalez may have paid their debt to society, it seems doubtful that the general public would understand an admitted Watergate burglar and active Republican using government funds to make loans to convicted Watergate burglars.

The circumstances surrounding the increase in capital raise a number of questions: How was De Diego able to repay the loans? To what extent were amounts drawn from the licensee for travel and entertainment expenses used to reduce these liabilities? What is the true source of this increase? Where did the $19,000 in currency come from? What is the source of these round-dollar amount checks? How accurate is the financial statement De Diego provided SBA?

What is the collateral for the loan from Cabal? The financial statement does not indicate any collateral and the most recent liability certificate states that licensee stock is not pledged. Does it seem reasonable that a Venezuelan would advance $100,000 to an American citizen to take to the United States without some form of collateral? Would a Venezuelan initiate a note written in English?

The circumstances regarding the increase in capital and the manner which De Diego acquired control of the licensee should be the subject of intense scrutiny. Unfortunately, time and subpoena authority was not authorized to make these inquiries. As a result, these matters should be considered unresolved and unanswered.

RECOMMENDATION

The Small Business Administration relies upon the integrity and good faith of individuals licensed to operate Small Business Investment Companies to conduct the affairs of the licensee in a business-like and forthright manner which will bring credit to the licensee, the industry and SBA.

Felipe De Diego has not operated Feyca Investment Company in such a manner. Through his actions and statements, he has shown that he does not have the requisite integrity. De Diego is more concerned with his personal aggrandizement than the maintenance of a solvent licensee.

In addition, De Diego has conducted the legitimate activity of the licensee in a most cavalier and inept fashion.

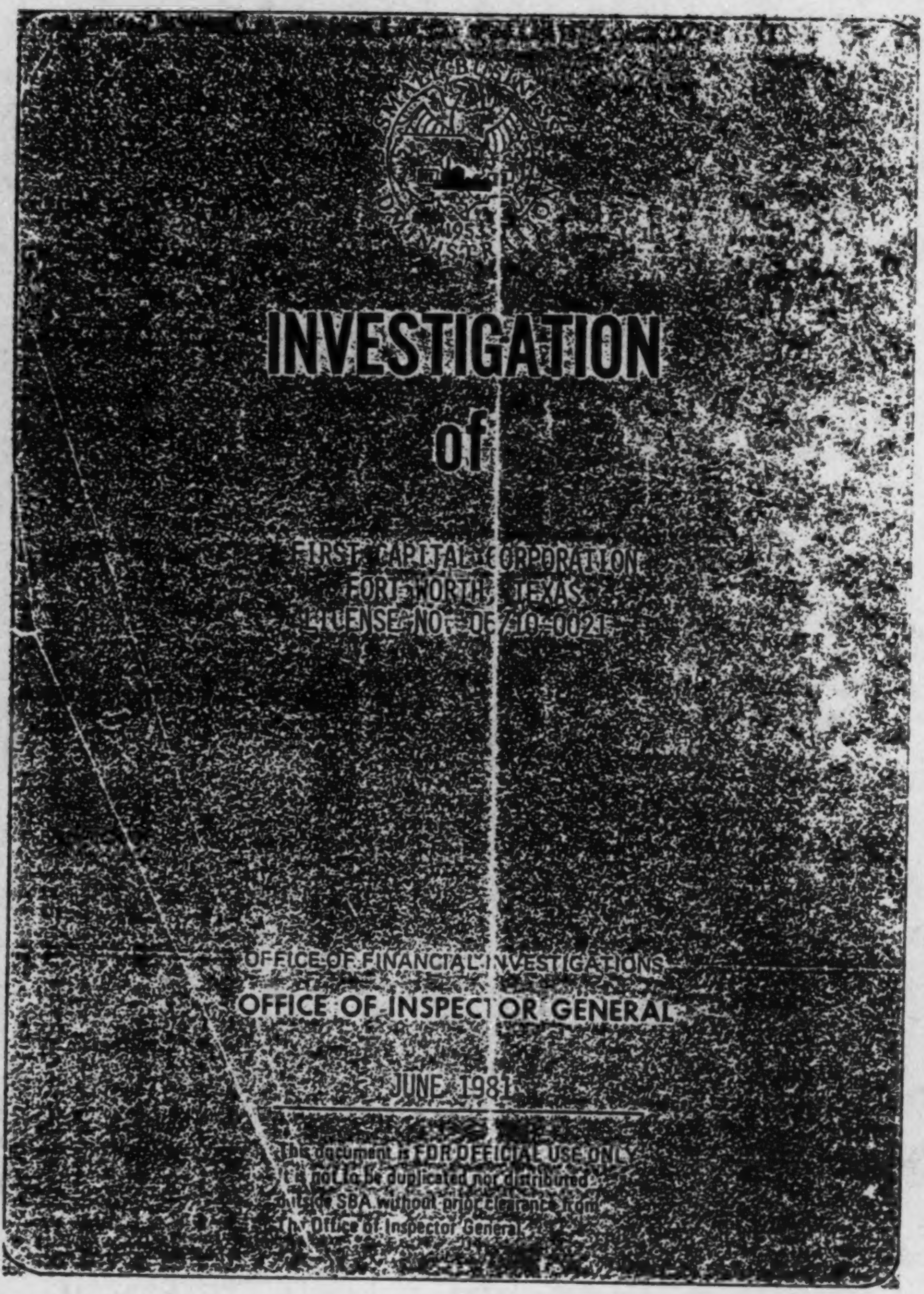
As long as De Diego operates the licensee, SBA cannot be secure in its status as creditor and investor. Accordingly, it is recommended that this case be transferred to the Office of Portfolio Management to initiate liquidation proceedings.

LIST OF EXHIBITS

EXHIBIT	DESCRIPTION
1.	American Express billings.
2.	Employment agreement.
3.	Schedule of personal travel paid by check to Biltmore and Trias travel agencies.
4.	Schedule of personal travel charged to American Express.
5.	Invoices relating to personal travel.
6.	Memorandum of interview with Felipe De Diego, dated August 20, 1982.
7.	Schedule of business travel paid by check to Biltmore Travel Agency.
8.	Schedule of business travel charged to American Express.
9.	Invoices relating to business travel.
10.	Schedule of draws for travel expenses.
11.	Receipts for travel expense draws.
12.	Schedule of U. S. hotel and motel charges to American Express.
13.	Schedule of charges to American Express for Venezuelan hotels, motels and restaurants.
14.	Schedules of charges to American Express for restaurants.
15.	Agreement with Jennifer Martin.
16.	Schedule of personal items paid by check.
17.	Schedule of personal charges to American Express, 1981.
18.	Schedule of personal charges to American Express, 1982.
19.	Memorandum of interview with Antonio C. Diaz, C.P.A., dated August 23, 1982.
20.	Letter of Roberto P. Perkins, dated July 7, 1982.

List of Exhibits (Con't)

EXHIBIT	DESCRIPTION
21.	Memorandum of interview with Roberto P. Perkins, dated August 20, 1982.
22.	Memorandum of interview with Felipe De Diego, dated August 23, 1982.
23.	SBA Form 415A.
24.	Personal financial statement of Felipe De Diego, dated December 31, 1980.
25.	Letter of Orlando Baro, dated January 7, 1981.



INVESTIGATION

of

FIRST CAPITAL CORPORATION
FORT WORTH, TEXAS
LICENSE NO. 06/10-0021

OFFICE OF FINANCIAL INVESTIGATIONS

OFFICE OF INSPECTOR GENERAL

JUNE 1981

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ATTENTION

Action taken or to be taken on the information contained in this report must be reported to the OFFICE OF INSPECTOR GENERAL, Attention: Assistant Inspector General for Investigations, within 30 days of the issue of the report.

This investigation was made in accordance with the policies and procedures contained in SOP 90 22 3.

Information contained in this report is to be disclosed only to responsible SBA personnel on a "need to know" basis. Disclosure of information to other than SBA personnel must not be made without the approval of the Inspector General and may only be done in compliance with the Freedom of Information Act (5 U.S.C. 552), and the Privacy Act of 1974, where applicable, as implemented by Agency policy, regulations, and SOP's (40 03, 40 04) and 18 U.S.C. 1905.

This report is issued by the Office of Financial Investigations, OFFICE OF INSPECTOR GENERAL.

Approved:

Marvin P. Shelton

Marvin P. Shelton, Director,
Office of Financial Investigations

Date JUN 29 1981

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Possible Misapplication of Funds - Title 18 U.S.C. Section 657;
Possible Conversion of Funds - Title 15 U.S.C. Section 645(c);
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REPORT ON INVESTIGATION
OF
FIRST CAPITAL CORPORATION
FORT WORTH, TEXAS
LICENSE NO. 06/10-00 21

INTRODUCTION AND SCOPE

The Office of the Inspector General ordered an investigation of First Capital Corporation (First Capital) of Fort Worth, Texas, to determine whether the licensee or other persons had violated any provisions of the Small Business Investment Act of 1958, as amended, or the regulations promulgated hereunder. The purpose of the investigation was to determine the source of funds reported as private-paid-in-capital; determine the relationship, if any, between First Capital and other Small Business Investment Companies (SBIC's); and to evaluate financings disbursed to and control exerted over, portfolio concerns by the licensee.

This investigation included a review of the books and records of First Capital, appropriate SBA files, and available records of selected portfolio companies. The president of First Capital Corporation was interviewed. In addition, responsible officials of selected portfolio companies (that could be located), and other third parties were contacted and interviewed to the extent deemed necessary.

This case was discussed with an Assistant United States Attorney for the Northern District of Texas. He recommended referral to the Department of Justice for possible criminal prosecution. Additional investigation will be made under the direction of the United States Attorneys Office.

Regulatory matters contained in the most recent examination report and not commented on herein should be evaluated based on the information and documentation available prior to the investigation.

SUMMARY

Principals of First Capital (the licensee) and the principals of some small business concerns, conspired to defraud the Government through misapplication of funds and by submitting false statements in order to receive additional funds. The licensee received SBA debenture funding totaling $3,375,000 subsequent to (and based in part) on reported private capital increases of $195,000 in August 1976; $300,000 in November 1978, and $125,000 in July 1979. This investigation disclosed that at least $40,000 of the $195,000 reported private capital increase was obtained by the licensee using Government funds and circular financing "schemes", whereby amounts reported as loans were returned to First Capital and claimed as private-paid-in-capital. In addition, similar manipulations were used for at least $225,000 of a reported $300,000 capital increase in November 1978. The total $125,000 capital increase claimed in July 1979, was obtained in a like manner. In attempts to conceal these actions, funds were disbursed to small business concerns and represented to the Government as loans. These funds were then deposited into accounts of these small business concerns, but subsequently returned to principals of the SBIC. These funds were then deposited in the account of the SBIC and claimed as private-paid-in-capital.

RECOMMENDATION

The Licensee has returned all government funds and requested SBA to accept surrender of the license; however, we recommend that SBA take no action regarding the license until the Department of Justice has completed any action it intends to take regarding this SBIC.

BACKGROUND

First Capital was incorporated in Texas, May 2, 1960, and licensed by the Small Business Administration, September 20, 1960. Effective May 6, 1975, control of the SBIC was assumed by the present ownership, and offices moved from Waco, Texas, to Ft. Worth, Texas. Messrs. John R. Payne and Harry S. Scaling are the principal owners. The stock distribution as of July 11, 1979, was as follows:

Name of Shareholder	Number of Shares
John R. Payne	36,100
Nola E. Payne (wife)	9,900
Harry S. Scaling	45,999
James F. Goodman	1
Total	92,000

Capital injections reported by the SBIC principals were as follows:

Date	Amount
5/7/75	$ 300.000.00
8/30/76	195,000.00
11/30/78	300,000.00
7/11/79	125,000.00
Total Cash Contributions	$ 920,000.00
Paid-in-Surplus	80,310.00
Total Capital Reported by the SBIC	$1,000,310.00

Funding requested, received, and outstanding as of the date this investigation was started is as follows:

Debenture #06-10-0021	Date	Amount	Leverage Ratio
1	9/24/75	$ 150,000.00	2:1
4	12/24/75	100,000.00	2:1
5	6/23/76	100,000.00	4:1
6	9/22/76	300,000.00	3:1
7	1/19/77	200,000.00	3:1
8	6/22/77	200,000.00	3:1
9	11/23/77	150,000.00	3:1
10	5/24/78	200,000.00	3:1
11	9/20/78	75,000.00	3:1
12	5/23/79	900,000.00	3:1
13	9/19/79	375,000.00	4:1
14	9/19/79	375,000.00	4:1
15	6/18/80	600,000.00	4:1
Total Funding		$3,725,000.00	

The $3,725,000 provided by the Government represented approximately $3.72 of leverage funds for each $1.00 of private capital claimed by the SBIC. ($3,725,000 divided by $1,000,310).

Subsequent to the start of this investigation, the SBIC forwarded its license to the Small Business Administration (SBA) and a check in the amount of $3,725,000 for the principal, plus another check in the amount of $44,230 for interest. The SBA refused to cancel the license pending the outcome of this investigation and the checks were returned to the SBIC. It is reported, that the indebtedness of First Capital was subsequently liquidated by wire transfer to the Federal Financing Bank for the principal and interest owed.

FINDINGS

Possible Conspiracy to Defraud SBA - Title 18 U.S.C. Section 371;
Possible False Statements - Title 18 U.S.C. Section 1001(b) and 1006 and Title 15 U.S.C. Section 645(a);
Possible Filing of False, Fictitious or Fraudulent Claims - Title 18 U.S.C. Section 287;
Possible Misapplication of Funds - Title 18 U.S.C. Section 657;
Possible Conversion of Funds - Title 15 U.S.C. Section 645(c);
Use of Funds for Prohibited Purposes - Section 107.1001(b);
Conflict of Interests - Section 107.1004(a) and (b);
False Filings Made to SBA Section 107.1008(b);

Principals of First Capital (the licensee) and the principals of some small business concerns, conspired to defraud the Government through misapplication of funds and by submitting false statements in order to receive additional funds. The licensee received SBA debenture funding totaling $3,375,000 subsequent to (and based in part) on reported private capital increase of $195,000 in August 1976; $300,000 in November 1978, and $125,000 in July 1979. This investigation disclosed that at least $40,000 of the $195,000 reported private capital increase was obtained by the licensee using Government funds and circular financing "schemes", whereby amounts reported as loans were returned to First Capital and claimed as private-paid-in-capital. In addition, similar manipulations were used for at least $225,000 of a reported $300,000 capital increase in November 1978. The total $125,000 capital increase claimed in July 1979, was obtained in a like manner. In attempts to conceal these actions, funds were disbursed to small business concerns and represented to the Government as loans. These funds were deposited into accounts of these small business concerns, but subsequently returned to principals of the SBIC. These amounts were deposited in the account of the SBIC and claimed as private-paid-in-capital.

> Title 18, U.S.C. Section 371 states that if two or more people conspire to commit any offense against the United States, defraud the United States or any Agency thereof in any manner or for any purpose and one or more such persons do any act to effect the object of the conspiracy they may be fined or imprisoned or both.
>
> Title 18, U.S.C. Section 1001 states that whoever, in any manner within the jurisdiction of any Department of Agency of the United States, knowingly and willfully, falsifies, conceals, or covers up by any trick, scheme, or device, a material fact or makes any false, fictitious or fraudulent statement or presentation or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, may be fined, imprisoned, or both.
>
> Title 18 U.S.C. Section 1006 provides that whoever knowingly makes any false entry in the books and records of any Small Business Investment Company with the intent to defraud may be fined, imprisoned, or both.
>
> Title 15 U.S.C. Section 645(a) states that whoever makes any statement knowing it to be false for the purpose of influencing in anyway the action of the Small Business Administration, or for the purpose of obtaining anything of value under Act, shall be subject to a fine or imprisonment or both.
>
> Title 18, U.S.C. Section 287 states that whoever makes or presents to any civil department or agency any claim upon or against the United States or any department

thereof knowing such claim to be false, fictitious or fraudulent could be fined or imprisoned or both. The Supreme Court of U.S. vs. Neifest-White Co., 390 U.S. 288 (1967) interpreted the False Claims Act to apply to the supplying of false information in support of a loan application.

Title 18, U.S.C. Section 657 states that whoever being an officer, employee, or connected in any capacity with any Small Business Investment Company and whoever being a receiver of such institution, embezzels, abstracts, purloins or willfully misapplies any money, funds, credits, or securities or other things of value belonging to such institution, or pledged or otherwise entrusted to its care, could be fined, imprisoned, or both.

Title 15, U.S.C. Section 645(c) states that whoever, with intent to defraud, knowingly disposes or converts to his own use or to that of another, any property mortgaged or pledged to the administration, shall be fined or imprisoned or both.

Section 107.1001(b) of SBA regulations state that no funds may be provided to a small concern directly or indirectly, for purchasing stock in or otherwise providing capital for a licensee, or to repay an indebtedness to accomplish such purpose.

Section 107.1004(a) of the SBA regulations provide that selfdealing to the prejudice of the small concern, or of a corporate licensee or its shareholders, or of SBA, is prohibited.

Section 107.1004(b) of SBA regulations provide that, except where a written exemption may be granted by SBA in special instances, a licensee shall not directly or indirectly provide financing to any of its associates.

Section 107.1008(b) of SBA regulations state that any false statement knowingly made, or misrepresentation or failure to state a material fact necessary in order to make a statement not misleading in the light of the circumstances under which the statement was made, in any document submitted to SBA shall constitute a violation of these regulations.

Filings Made To SBA By Principals of The SBIC and Others in Reporting a $195,000 Capital Increase August 30, 1976

On August 27, 1976, a principal of the SBIC (John R. Payne) caused Lee Mc Cleary, president of Regional Manufacturing Company, Inc., (Regional) to execute a loan agreement for $40,000. On the same day Mr. Mc Cleary executed a "note payable" in favor of First Capital for an identical amount. In turn, check number 272 signed by John R. Payne and drawn on the First Capital checking account, number 1 23349, at the Bank of North Texas, Hurst, Texas, was issued to Regional. This check, in the amount of $40,000 was deposited in the Regional checking account, number 1 23430, at the Bank of North Texas, August 30, 1976.

On the same day these funds were deposited into the Regional account, Mr. Mc Cleary issued check number 781 payable to the Bank of North Texas for $40,000. The back of check number 781 shows ". . . for cc to Harry S. Scaling . . . ." Based on this disbursement from Regional; the Bank of North Texas issued a cashier's check, number 002435, payable to Harry S. Scaling in the amount of $40,000. This check was deposited into the First Capital checking account, number 1 23349, on the same day, and claimed as a portion of the $195,000 increase in private-paid-in-capital reported to SBA by the licensee.

The Bank of North Texas wrote a letter, dated August 30, 1976, to SBA which states, "This letter is confirming to you that . . . funds available in the amount of $195,000 that are free and unencumbered at this bank have been deposited in an account styled First Capital Corporation." Mr. Payne signed a memorandum dated August 30, 1976, which claims that the $195,000 was used for an increase in capitalization.

John R. Payne submitted a "Portfolio Financing Report," SBA Form 1031, dated August 31, 1976, to SBA. This form contains representations that the funds were loaned to Regional to be used for the purchase of new equipment and to pay short term debt. The SBA Form 1031 contains a verification which prescribes ". . . the information . . . is certified to be complete and correct to the best of my knowledge and belief. . . . "

Mr. Mc Cleary was interviewed during this investigation. He verified the events concerning the $40,000 through the time the cashier's check was purchased, but stated that he did not know how Scaling used the funds subsequent to that transaction. Mc Cleary said that Mr. Scaling was a former banker with whom he had done business in the past. Mc Cleary stated that at the time of this occurrence the only difference so far as he was concerned was that Scaling was providing funds from First Capital in lieu of a bank. He stated that Scaling told him he would use the $40,000 to pay some "notes payable" owed by Regional, but he Mc Cleary was "tricked", as he later found the "notes" had not been paid.

A sworn statement was prepared which summarized the events. Mr. Mc Cleary read the statement and agreed with the contents but did not wish to sign it.

Subsequent to this claimed capital increase, principals of the SBIC submitted documentation to SBA on ten occasions, which represented the $40,000 as a part of the private capital. In each of the ten instances principals of the SBIC executed certifications containing criminal penalites for false statements or representations under provisions of the appropriate United States Code.

Filings Made To SBA By Principals of The SBIC and Others in Reporting a $300,000 Capital Increase on November 20, 1978

On November 13, 1978, principals of the SBIC (John R. Payne and Harry S. Scaling) and Charles F. White II, of W & S Construction Company, and Datco, Incorporated, executed checks and other documents showing loans of $225,000 from First Capital.

First Capital's check number 718, in the amount of $50,000, was drawn on their checking account, number 1 23349, at the Bank of North Texas. The check was dated November 13, 1978, and made payable to Datco, Inc. First Capital's check number 719, in the amount of $175,000, was also drawn on their checking account, number 1 23349, at the Bank of North Texas. This check was dated November 13, 1978, and made payable to W & S Construction Company, Inc.

These two checks were executed by Mr. White and deposited at the First National Bank of Madill, Madill, Oklahoma, on November 15, 1978. They were deposited to a checking account, number 12 1906, known as White Construction Company.

On November 16, 1978, Mr. White issued White Construction Company check number 251 to Harry S. Scaling. The check was for $225,000. Mr. Scaling endorsed this check and deposited it in First Capital's checking account, number 1 23349, at the Bank of North Texas on November 17, 1978.

This $225,000 was represented to the Government as part of a claimed $300,000 private-paid-in-capital increase on November 20, 1978. On December 5, 1978, the Bank of North Texas sent a letter to SBA which states "This letter is to inform you that First Capital Corporation had deposited to its account $300,000 on 11/20/78, by Harry S. Scaling and John R. Payne. These funds were and are free and unencumbered." In addition, SBA Form 415C, Amendments To License Application, was sent to SBA by First Capital. This form showed that on November 20, 1978, the licensee increased its capital stock by 30,000 shares ($300,000). This form, dated December 6, 1978, was signed by John R. Payne and Harry S. Scaling.

Mr. White was interviewed during this investigation. He confirmed that he had received the $225,000 from First Capital. Mr. White claimed he had borrowed the funds from First Capital for the intended purpose of paying some debts but had subsequently decided to invest the money in a firm owned by Mr. Scaling known as B - P Industries, Incorporated. Mr. White claimed that B - P Industries had planned to merge with a firm known as Wymont Oil Corporation which had some oil property. This did not materialize, according to White, and as B - P Industries was only a "public shell" his investment of $225,000 paid to Mr. Scaling was of little or no value.

By definition Mr. Scaling is an "associate of the licensee" as he is an officer of First Capital and owns more than ten percent of the licensee's stock.

John R. Payne submitted a "Portfolio Financing Report," SBA Form 1031, dated November 16, 1978, to SBA for the $175,000 disbursement to W & S Construction Company. These funds, per the report, were to be used to purchase and develop oil and gas properties. Mr. Payne submitted another SBA Form 1031, dated May 16, 1979, to SBA for the $50,000 disbursement to Datco, Inc. He again claimed that these funds were to be used to purchase and develop oil and gas properties. He did not disclose that the disbursements were to the same person. Also, the report to SBA pertaining to Datco was not made for some six months after the disbursement (November 1978 to May 1979) even though the checks are both dated the same day.

Subsequent to this claimed capital increase, principals of the SBIC submitted documentation to SBA on four occasions and represented this amount as part of the private capital. In each of the four instances, principals of the SBIC executed certifications containing criminal penalties for false statements or representations under provisions of the United Stated Code. Based on these representations, they received $2,250,000 in Government funding (funds from these four instances are included in the $3,375,000 summarized by the previous finding).

Filings Made To SBA By Principals of The SBIC and Others in Reporting a $125,000 Capital Increase on July 11, 1979

On July 9, 1979, principals of the SBIC (John R. Payne and Harry S. Scaling) and Mr. R. F. Needham, the principal of a small business concern known as R. F. Needham and Associates, Inc., executed checks and other documents showing a loan of $130,000 from First Capital.

First Capital's check number 182, in the amount of $130,000, was drawn on checking account, number 023 645 5, at the First National Bank of Fort Worth, Fort Worth, Texas. The check was dated July 9, 1979, and made payable to R. F. Needham and Associates, Inc.

This check was deposited to the account of R. F. Needham and Associates Inc., checking account, number 032 280 0, at the Continental National Bank, Fort Worth, Texas, on July 9, 1979. On the same date, Mr. Needham issued his check number 428, in the amount of $125,000, made payable to C. Gordon Arnold, Jr. That check was deposited to account number 102 6950, at the Continental National Bank of Fort Worth in the name of the C. Gordon Arnold Estate. On July 10, 1979, Mr. Harry S. Scaling issued check number 144 from the account of C. Gordon Arnold Estate in the amount of $125,000. The check was made payable to H.P.S. and endorsed as "H.P.S. by John R. Payne for deposit only First Capital Corp. account no 023 645 5." It was deposited at the First National Bank of Fort Worth on July 11, 1979, and claimed as private-paid-in-capital.

Harry Scaling signed a "note payable" to the C. Gordon Arnold, Jr. Estate in the amount of $125,000. In attempting to conceal the circular financing scheme, Messrs. Needham and Scaling executed a sales contract on some real estate for $125,000. The contract contained clauses to the effect the buyer (Needham) had an option as to whether the sale would be consummated, and all lease income would be held by the seller (Scaling). During an interview Mr. Needham told the investigator he did not exercise his option to purchase the real estate and $125,000 of the amount owed to First Capital was cancelled.

During this investigation John Payne furnished documentation which purported that he and Scaling borrowed the $125,000 from Scalings uncle's estate.

John R. Payne submitted an SBA Form 1031, dated August 9, 1979, to SBA which shows the funds provided to R. F. Needham and Associates were to be used for working capital to finance the building of solar homes.

The First National Bank of Fort Worth issued a letter to SBA dated August 8, 1979, which states "This letter is to inform you that First Capital Corporation had deposited to its account $125,000 on July 11, 1979, by Harry S. Scaling and John R. Payne. These funds were and are free and unencumbered."

Based on this claimed capital increase First Capital (John Payne) provided a memorandum to SBA showing that he and Scaling each purchased 6,250 shares of stock in the SBIC at $10 per share. Subsequent to this representation, principals of the SBIC applied for and received proceeds from the sale of debentures on three occasions. In each of the three instances principals of the SBIC executed certifications containing criminal penalties for false statements or representations under provisions of the United States Code. The value of these funds received by the SBIC for the sale of debentures was $1,350,000 (funds from these three instances are included in the $3,375,000 summarized by the previous findings).

Relationship Between First Capital and Other SBIC's

This investigation did not reveal any relationship with other SBIC's except for some joint financings.

ATTACHMENT NO. 1
TO
REPORT ON INVESTIGATION
OF
FIRST CAPITAL CORPORATION
FORT WORTH, TEXAS
LICENSE NO. 06/10-00-21

LEADS PERTAINING TO POTENTIAL ADDITIONAL VIOLATIONS

The investigation has, to date, disclosed several additional transactions which are questionable. They may constitute additional criminal actions by principals of the SBIC and others. However, they have not been fully developed and are provided for information and further investigation as deemed necessary.

First Capital Corporation reported to SBA that $175,000 in loans had been made to a firm known as Gold Belt Mining Company (Gold Belt). This investigation disclosed that, in addition to writing checks to Gold Belt from First Capital, John Payne, issued checks on the Gold Belt account payable to the SBIC and others. Mr. Payne made one disbursement of $115,000 to Gold Belt on January 1[illegible], 1979. On February 19, 1979, he issued a check from Gold Belt for $115,000 payable to First Capital Corporation. Another disbursement of $40,000 was made to Gold Belt. From this reported loan the $40,000 was provided directly to another small business concern known as Great

Frontier Land and Mineral (Great Frontier) by checks signed by John Payne and issued on the Gold Belt account.

First Capital Corporation reported to SBA that $200,000 in loans had been made to Great Frontier. The investigation disclosed that this firm may have received in excess of $550,000 from the SBIC either directly or indirectly by the use of a "scheme" whereby funds were disbursed to another small business and subsequently transferred to Great Frontier. John Payne and Harry Scaling had signature authority on the Great Frontier account. One check for $16,800 from the Great Frontier account was made payable to the Scaling V. Ranch. That check was signed by John R. Payne. The further disposition of these funds was not determined.

First Capital Corporation reported to SBA that $200,000 in loans had been made to a business known as Pioneer Powder Coatings, Inc., (Pioneer). This investigation disclosed that Harry Scaling had signature authority on the Pioneer account. One check for $15,000 was issued on Pioneer, made payable to Harry S. Scaling, and signed by Scaling. Another check for $15,000 was made payable to Martha Scaling and signed by Scaling. A third check for $30,000 was made payable to Harry Scaling and also signed by him.

In August 1978, First Capital Corporation provided a firm known as Rock Creek Enterprises (Rock Creek) with $55,000. Mr. Charles F. White is the owner of Rock Creek. These funds were deposited into the Rock Creek account, and from this account a $30,000 check was issued to John Payne. During an interview on March 23, 1981, Mr. White said he did not know the purpose of the $30,000 check to Mr. Payne. The $25,000 balance from the $55,000 reported loan was paid to Great Frontier. Mr. White could not explain the purpose of the check issued to Great Frontier.

In August 1975, First Capital Corporation provided funds of $75,000 to a firm known as World Trade (Gene Chatham). These funds were deposited into Chatham and Associates account, and a $75,000 check written on that account to R. J. Hudiburg. During an interview on January 21, 1981, Mr. Chatham said R. J. Hudiburg was his ex-brother-in-law. He said Hudiburg had asked World Trade to obtain the funds from the SBIC and provide them to him for some deal "they" were working on. Mr. Chatham stated he didn't know who "they" were. Hudiburg executed a "note" in favor of World Trade for the $75,000. In addition, a $1,000 check written on Pioneer Powder Coatings account and dated April 5, 1979, shows the payee as Hudiburg, Scaling and Payne. The check shows it was deposited in the name of

Hudiburg, Scaling and Payne. The investigaton disclosed that Hudiburg had paid the World Trade note due to First Capital by receiving another loan from the SBIC. When Mr. Hudiburg was asked why he paid a "note" owed by another firm, he said it was because the funds had been used in an attempt to establish a dealership in Corpus Christi, Texas, which had not developed. Mr. Hudiburg stated he, therefore, thought that either he or his company should pay the debt.

LIST OF EXHIBITS

The original exhibits are maintained in the files of the Office of Financial Investigations, Office of the Inspector General.

1. Copy of SBA Form 1022, March 1975 and February 1979, Application for Guaranty Pursuant to Section 303(b) of the Small Business Act of 1958, as amended, from the period July 15, 1975 thru May 1, 1980.

2. Copy of SBA Form 444C, September 1974, and June 1979, Debenture, from the period September 24, 1975 thru June 18, 1980.

3 Summary of Applications for Guaranty by, and Debentures to the SBIC.

4. Summary Schedule of Applications made for Guaranty, and Financings received by the SBIC subsequent to a claimed capital increase of $195,000 in August 1976, of which $40,000 was obtained by circular financings.

5. Summary Schedule of Applications made for Guaranty, and Financings received by the SBIC subsequent to a claimed capital increase of $300,000 in November 1978, of which $225,000 was obtained by circular financings.

6. Summary Schedule of Applications made for Guaranty, and Financings received by the SBIC subsequent to a claimed capital increase of $125,000 in July 1979, of which the $125,000 was obtained by circular financings.

7. Copy of General Ledger which shows capital increases claimed by principals of the SBIC.

✓ 8. Copy of Flow Chart showing circular financings claimed as capital increases for $40,000; $225,000; and $125,000 in August 1976; November 1978; and July 1979, respectively.

9. Copy of Loan Agreement executed by Lee Mc Cleary; President of Regional Manufacturing Company, Incorporated; in August 1976; for $40,000.

10. Copy of Note Payable in the amount of $40,000 executed by Lee Mc Cleary of Regional Manufacturing Company in favor of First Capital Corporation.

11. Copy of Check from First Capital Corporation to Regional Manufacturing Company in the amount of $40,000 dated August 27, 1976.

12. Copy of Deposit Ticket to the account of Regional Manufacturing Company at the Bank of North Texas in the amount of $40,000.

13. Copy of SBA Form 1031, Portfolio Financing Report, dated August 31, 1976, from First Capital Corporation to SBA purporting a $40,000 financing to Regional Manufacturing Company.

14. Copy of Check from Regional Manufacturing Company to Bank of North Texas in the amount of $40,000 dated August 30, 1976.

15. Copy of Cashier's Check from the Bank of North Texas payable to Harry S. Scaling, dated August 30, 1976.

16. Copy of Bank Statements for Regional Manufacturing Company at the Bank of North Texas for period ended August 31, 1976.

17. Copy of Bank Statements and Deposit Tickets for First Capital Corporation at the Bank of North Texas showing the claimed $40,000 and $155,000 capital increase in August 1976.

✓ 18. Copy of Letter from President of the Bank of North Texas, dated August 30, 1976, to SBA purporting that First Capital Corporation had $195,000 in unencumbered funds available.

✓ 19. Copy of Letter from President of First Capital Corporation, dated August 30, 1976, to SBA claiming that John Payne purchased 11,500 shares of stock and Harry Scaling purchased 8,000 shares of stock at $10 per share.

20. Sworn Statement prepared for the signature of Lee Mc Cleary, of Regional Manufacturing Company, which is not signed but facts agreed to by Mr. Mc Cleary.

21. Copy of First Capital Corporation, Check Number 718 and Number 719 dated November 13, 1978, in the amount of $50,000 and $175,000 respectively made payable to Datco, Inc., and W & S Construction Co., Inc., which were endorsed by C. F. White and negotiated at the First National Bank in Madill.

22. Copy of Deposit Ticket for November 15, 1978, for White Construction Company at the First National Bank in Madill showing a deposit of $225,000.

23. Copy of Bank Statement from First National Bank in Madill, for White Construction Company for the period ended November 30, 1978, showing the deposit and withdrawal of the $225,000.

24. Copy of Signature Card for White Construction Company at the First National Bank in Madill.

25. Copy of Check written to Harry S. Scaling in the amount of $225,000 from the account of White Construction Company at the First National Bank in Madill, and negotiated at the Bank of North Texas.

26. Copy of Deposit Ticket for Harry S. Scaling at the Bank of North Texas showing a $225,000 deposit.

27. Copy of Bank Statement for First Capital Corporation at the Bank of North Texas for period ended November 30, 1978, showing withdrawals of $175,000 and $50,000 and deposit of the $225,000.

✓ 28. Copy of Letter from President of the Bank of North Texas, dated December 5, 1978, to SBA purporting that First Capital had $300,000 in unencumbered funds available.

✓ 29. Copy of SBA Form 415C, April 1977, Amendments to License Application, dated December 6, 1978, reporting the sale of 30,000 shares of stock and purporting a $300,000 increase in private capital.

30. Copy of SBA Form 1031, Portfolio Financing Report, dated November 16, 1978, from First Capital Corporation to SBA reporting a $175,000 financing to W & S Construction Company.

31. Copy of SBA Form 1031, Portfolio Financing Report, dated May 16, 1979, from First Capital Corporation to SBA reporting a $50,000 financing to Datco, Incorporated.

32. Memorandum of Interview with Charles White of W & S. Construction Company, Rock Creek Enterprises and Datco Corporation on March 23, 1981.

33. Copy of Agreement or Contract between B-P Industries and Wymont Oil Corporation.

34. Copy of Memorandum dated February 28, 1979, and Transfer Documents applicable to some leases in Oklahoma, from Charles F. White to Oklahoma Industrial Enterprises.

35. Copy of Transmittal from Charles F. White showing specimen signature.

36. Copy of Bank Statement for R. F. Needham and Associates at the Continental National Bank of Fort Worth for the period ending July 31, 1979, which includes the deposit of $130,000 and the withdrawal of $125,000.

37. Copy of Check from First Capital Corporation to R. F. Needham and Associates in the amount of $130,000, dated July 9, 1979.

38. Copy of Check from R. F. Needham and Associates to C. Gordon Arnold, Jr., in the amount of $125,000, dated July 9, 1979.

39. Copy of Check from C. Gordon Arnold Estate to H.P.S., signed by Harry S. Scaling, in the amount of $125,000, dated July 10, 1979, drawn on Continental National Bank of Fort Worth, endorsed by John Payne and deposited at the First National Bank of Ft. Worth.

40. Copy of Notes Payable from H.P.S. (Harry Scaling) in favor of C. Gordon Arnold, Jr. Estate dated July 10, 1979, in the amount of $125,000.

41. Copy of Sales Contract, dated July 9, 1979, between Harry S. Scaling (Agent) and R. F. Needham and Associates represented as an option to purchase some real property for $125,000.

42. Copy of Note for $200,000 payable to First Capital Corporation from R. F. Needham and Associates.

43. Copy of Bank Statement for First Capital Corporation at the First National Bank of Fort Worth for period ended July 31, 1979, showing the withdrawal of $130,000 and deposit of $125,000.

44. Copy of Letter from Senior Vice President of the First National Bank of Fort Worth, dated August 8, 1979, to SBA purporting that First Capital Corporation had $125,000 in unencumbered funds available.

✓ 45. Copy of SBA Form 415C, April 1977, Amendments to License Application, dated July 11, 1979, reporting the sale of 12,500 shares of stock and purporting a $125,000 increase in private capital.

46. Copy of Letter from John Payne to SBA dated July 11, 1979, claiming that John Payne and Harry Scaling had invested $125,000 in cash for the purchase of an additional 12,500 shares of stock.

47. Copy of SBA Form 1031, Portfolio Financing Report, dated August 9, 1979, from First Capital Corporation to SBA showing financing, to R. F. Needham and Associates of $190,000.

48. Copy of Check from First Capital Corporation to Gold Belt Mining Company in the amount of $40,000, dated February 21, 1979.

49. Copy of Deposit Ticket to the account of Gold Belt Mining Company at Red Bird Bank of Dallas in the amount of $40,000.

50. Copy of Bank Statement for Gold Belt Mining Company at the Red Bird Bank of Dallas showing the deposit and withdrawal of the $40,000.

51. Copy of Check from Gold Belt Mining Company to Great Frontier Land and Mineral Company dated March 23, 1979, in the amount of $40,000 which shows that Cashier's Checks were purchased by John Payne with the proceeds.

52. Copy of SBA Form 1031, Portfolio Financing Report, dated February 21, 1979, from First Capital Corporation to SBA reporting a $40,000 financing to Gold Belt Mining.

53. Copy of Check from First Capital Corporation to Gold Belt Mining Company in the amount of $115,000, dated January 14, 1979.

54. Copy of Deposit Ticket to the account of Gold Belt Mining Company at Red Bird Bank of Dallas in the amount of $115,000.

55. Copy of Bank Statement for Gold Belt Mining Company at Red Bird Bank of Dallas showing the deposit and withdrawal of the $115,000.

56. Copy of Check from Gold Belt Mining Company to First Capital Corporation dated February 19, 19789, in the amount of $115,000.

57. Copy of SBA Form 1031, Portfolio Financing Report, dated January 24, 1979, from First Capital Corporation showing a $120,000 financing to Gold Belt Mining.

58. Copy of Check from First Capital Corporation to Gold Belt Mining Company in the amount of $15,000, dated December 1, 1978.

59. Copy of Deposit Ticket to the account of Gold Belt Mining Company at Red Bird Bank of Dallas in the amount of $15,000.

60. Copy of Bank Statement for Gold Belt Mining Company at Red Bird Bank of Dallas showing the deposit of the $15,000 and withdrawal of $14,000.

61. Copy of Check from Gold Belt Mining Company to Great Frontier Land and Mineral Company dated December 5, 1978, in the amount of $14,000.

62. Copy of Check from First Capital Corporation to Gold Belt Mining Company in the amount of $5,000 dated January 4, 1979.

63. Copy of Deposit Ticket to the account of Gold Belt Mining Company in the amount of $5,000.

64. Copy of Bank Statement for Gold Belt Mining Company at Red Bird Bank of Dallas showing the deposit and withdrawal of the $5,000.

65. Copy of Check from Gold Belt Mining Company to Great Frontier Land and Mineral Company for $5,000 dated January 1, 1979.

66. Copy of SBA Form 1031, Portfolio Financing Report, dated December 1, 1978, from First Capital Corporation to SBA showing a $15,000 financing.

67. Copy of Document purporting the company history and description of Gold Belt Mining Company per John Payne.

68. Summary of Major Financings to Gold Belt Mining Company and Disposition of those funds by Gold Belt.

69. Copy of Signature Cards for Rock Creek Enterprises at the Bank of North Texas.

70. Copy of Bank Statement for Rock Creek Enterprises for period ending September 29, 1978.

71. Copy of Check from First Capital Corporation to Rock Creek Enterprises in the amount of $55,000 dated September 21, 1978; and Copy of Deposit Ticket for September 1978.

72. Copy of Check from Rock Creek Enterprises to Great Frontier Land and Mineral Co., Inc., dated September 21, 1978, in the amount of $25,000; and Copy of Check to John R. Payne dated September 21, 1978, in the amount of $30,000.

73. Copy of Document purporting the company history of Pioneer Powder Coatings, Incorporated per John Payne.

74. Copy of SBA Form 1031, Portfolio Financing Report, from First Capital Corporation to SBA showing financings of $162,950; $11,050; and $4,000 dated June 29, 1979; November 15, 1979; and March 26, 1980.

75. Summary of Schedule of Financings to Pioneer Powder Coatings.

76. Copy of Signature Card for Pioneer Powder Coatings showing that Harry Scaling (of the SBIC) had signature authorized.

77. Copy of Check signed by Harry S. Scaling from Pioneer Powder Coatings made payable to Harry S. Scaling (of the SBIC) in the amount of $15,000; Copy of Check from Pioneer Powder Coatings signed by Harry S. Scaling made payable to Martha May Scaling in the amount of $15,000; and Copy of Check signed by Harry S. Scaling dated June 19, 1979, to Harry S. Scaling in the amount of $30,000.

78. Copy of Check signed by Billie R. Campbell (of the SBIC) from Pioneer Powder Coatings made payable to Kiamichi Wilderness (another portfolio company) in the amount of $7,000; and Copy of Check signed by Harry S. Scaling dated June 25, 1979, in the amount of $10,000.

79. Copy of Check signed by Billie R. Campbell (of the SBIC) from Pioneer Powder Coatings made payable to Hudiburg, Scaling and Payne in the amount of $1,000.

80. Copy of Checks signed by Billie R. Campbell (of the SBIC) from Pioneer Powder Coatings to Great Frontier Land and Mineral (another portfolio company) in the amount of $3,000; another check for $3,000; and one for $1,000.

81. Summary Schedule of Financing to Handcock Publishing Company, d/b/a, Vikon Village Flea Market.

82. Copy of Checks from Handcock Publishing Company, d/b/a, Vikon Village Flea Market to Great Frontier Land and Mineral (another portfolio company).

83. Copy of Document purporting the company history of Great Frontier Land and Mineral Company per John Payne.

84. Copy of SBA Form 1031, Portfolio Financing Report, from First Capital Corporation to SBA showing financings to Great Frontier Land and Mineral per John Payne.

85. Copy of Checks and Debit Memo from First Capital Corporation to Great Frontier Land and Mineral Company for financings.

86. Summary Schedule of Financings to Great Frontier Land and Mineral Company from First Capital Corporation, and from other portfolio companies that received funds from First Capital Corporation.

87. Copy of Signature Card for Great Frontier Land and Mineral, Incorporated at Fort Worth Bank and Trust.

✓ 88. Documentation provided to Financial Investigator summarizing sources of funds for capital increases as claimed by John Payne.

89. Copy of Check for $16,800 from Great Frontier Land and Mineral to Scaling V. Ranch.

90. Copy of Check from First Capital Corporation for $75,000 from First Capital to World Trade dated July 7, 1975.

91. Copy of Note Payable from World Trade to First Capital Corporation for $75,000 dated July 7, 1975.

92. Copy of Deposit Ticket for World Trade on July 14, 1975, for $75,000.

93. Copy of Check from World Trade for $75,000 to Robert J. Hudiburg on July 15, 1975.

94. Copy of Note Payable from Robert J. Hudiburg to World Trade Association on July 14, 1975.

95. Copy of Check from First Capital Corporation for $175,000 to Mid-Cities Enterprises, Incorporated (Robert J. Hudiburg) on November 13, 1978, showing the purchase of cashier's checks 30 260, 30 261, and 30 262.

96. Copy of Cashier's Check 30 262 in the amount of $61,279 on November 17, 1978, payable to First Capital Corporation which shows Chatham and Associates as the remitter.

✓97. Memorandum of Interview with John Payne of First Capital Corporation on November 14, 1980.

98. Memorandum of Interview with Lee Mc Cleary of Regional Manufacturing Company on December 3, 1980.

99. Memorandum of Interview with Harry Flewelling of Oklahoma Industrial Energy on December 9, 1980.

100. Memorandum of Interview with Garry Handcock of Handcock Publishing Company on January 28, 1981.

101. Memorandum of Interview with Ed Fitzgerald and Garry Handcock of Gold Belt Mining Company on January 27 and January 28, 1981.

102. Memorandum of Interview with Charles F. White of Rock Creek Enterprises, W & S Construction Company, White Construction Company, and Datco Computer Company on January 19, 1981.

103. Memorandum of Interview with Kenneth Swaringen of Mid-Cities Enterprises on December 16, 1980.

104. Memorandum of Interview with R. J. Hudiburg of Mid-Cities Enterprises on December 17, 1980.

105. Memorandum of Interview with Gene Chetham of World Trade Associates on January 21, 1981.

106. Copy of Cash Disbursements Journal for First Capital Corporation showing a $40,000 Check to Regional Manufacturing Company.

107. Copy of Cash Disbursement Journal for First Capital Corporation showing $50,000 and a $175,000 Check to Datco, Incorporated, and W & S Construction.

108. Copy of Cash Disbrusements Journal for First Capital Corporation showing a $130,000 Check to R. F. Needham & Associates.

109. Copy of Cash Receipts Journal for First Capital Corporation showing the $195,000 claimed capital increase in August 1976.

110. Copy of Cash Receipts Journal for First Capital Corporation showing the $300,000 claimed capital increase in November 1978.

111. Copy of Cash Receipts Journal for First Capital Corporation showing the $125,000 claimed capital increase in July 1979.

112. Copy of pertinent pages of SBA Form 468, Financial Report, showing financings to and receivables from selected portfolio companies for the period ending March 31, 1976; March 31, 1977; March 31, 1978; and March 31, 1979.

✓ 113. Copy of complete SBA Form 468 for period ending March 31, 1980, showing certifications and verifications by principals of the SBIC.

114. Memorandum of Interview with R. F. Needham on March 18, 1981.

✓ 115. Memorandum of Interview with John Payne on April 2, 1981.

✓ 116. Memorandum of Interview with R. H. Wallace, Assistant United States Attorney on April 30, 1981.

117. Memorandum of Observation, Re: Relationship between First Capital Corp. & other SBICs.

LIST OF SUPPLIEMENTAL EXHIBITS

The original exhibits are maintained in the files of the Office of Financial Investigations, Office of the Inspector General.

A. Copy of Report of Examination for the period ending March 31, 1980.

B. Copy of Referral from Compliance Audit Division Investigation Order.

✓ C. Copy of Memorandum from First Capital Corporation to SBA requesting that they be terminated from the SBIC Program.

D. Copy of Memorandum from SBA to First Capital Corporation returning checks and informing them that their SBIC License will not be accepted until completion of this investigation.

E. Copy of Correspondence and Documentation relating to the purchase of the SBIC.

F. Copy of Subpoena Duces Tecums.

G. Copy of Motion for Order Pursuant to Customer Challenge Provisions of the Right to Financial Privacy Act of 1978, and related data.

H. Copy of Court Order pertaining to Subpoena Duces Tecums.

SBA

Inspector General Management Advisory Report

U.S. Small Business Administration
Office of Inspector General

Subject: Idle Funds/Inactivity
Program: Small Business Investment Company
Date: October, 1981
Number: MAR 81-1

INTRODUCTION

The Office of Inspector General has established a system of Management Advisory Reports (MAR's) designed to focus the attention of Agency officials on aspects of Agency programs and operations which we perceive to present significant actual or potential problems. MAR's are specifically intended to implement that portion of the Inspector General Act of 1978 which requires Inspectors General "to recommend policies for activities designed to promote economy, efficiency, and effectiveness in the administration of programs and operations."

MAR's are neither audit nor investigation reports, although they frequently rely on those reports in drawing conclusions concerning patterns or trends. MAR's are developed using the best facts available to us. The analysis of those facts is grounded in the experience gained in the process of hundreds of audits and investigations each year.

No MAR is intended to be the last word on a particular topic. We developed the MAR to open or to reopen Agency inquiry into developments affecting methods of operation which may need Agency attention. We invite full and searching discussion into these issues, including the correction of any misunderstanding on our part. The result of this discussion will be, we hope, the improved administration of the Agency and a better understanding by all concerned of the causes, effects, and relationships that surround its operations.

SMALL BUSINESS INVESTMENT COMPANY PROGRAM

TOPIC: INACTIVITY AND IDLE FUNDS

We recently commented on several portions of proposed changes to regulations governing the Small Business Investment Company (SBIC) program. During our consideration of those proposed changes, our attention was once again drawn to the fact that a large amount of funds in this program is idle, that is, these funds are not being used for both equity and long-term loan financing of small businesses as the Small Business Act intends.[1] Idle funds are maintained in either cash or other interest-bearing investment certificates as the regulations provide.

Based on figures available to us, we estimate that these idle funds presently may amount to as much as $500 million.[2] Besides being a large amount of money in itself, this figure is interesting when its relationship to the program as a whole is contemplated. The total Government and private capital invested in this program is $1.6 billion. The total Government share of the program alone is $881.6 million. Thus, it could be said that idle funds equal about one-third of the total investment and that they equal about one-half of the Government's share.

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[1] 15 U.S.C. 661.

[2] This estimate is based on the ratio we found in 345 "reporting" SBIC's where idle funds equaled $321 million. Assuming that the remainder of the approximately 500 SBIC's carry similar idle balances, we estimate $500 million to be the approximate total balance. These estimates include both regular SBIC's and 301(d) Minority Enterprise SBIC's. Our review of these 345 companies also disclosed that 25 percent of the assets of this group of companies were in cash or idle funds and that MESBIC's accounted for 20 percent of the idle funds total. Significantly, when viewed separately, MESBIC idle fund amounts were 42 percent of the total assets in the 301(d) program.

These comparisons, as well as the $500 million amount itself, suggest that Government participation in funding this program might be reduced considerably without harming small businesses.[3] We do not intend to minimize the many legal and technical complexities that may attend any effort to reduce the Government's share in proportion to the amount of idle funds. Nevertheless, if idle funds in this program are viewed as excess capacity in the SBIC industry as a whole, it should follow that additional Government investment would increase the excess capacity. We reviewed the most recent three-year period in this regard and discovered that this effect did occur, that is, idle funds in the program increased in almost the same amounts as Government investment.[4] If it is true that idle funds represent excess capacity in this industry, then there would arise a danger that continued leveraging without corrective action will simply increase the amount of idle funds. It would appear, therefore, that not only the amount of idle funds, but the manner in which it appears to be growing are factors which merit prompt Agency attention.

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[3] In all likelihood, the Government share could be reduced even more than the amount of the idle funds without touching the fundamental capital investment purpose of the program. Of the non-idle capital invested in the program, we found that 29.4 percent is in equity interests. The remaining 71.6 percent is in the form of loans, either debt securities (23.4 percent) or regular loans ([illegible]7.2 percent). It would appear from these facts that if small business demand for equity capital exceeds these amounts, SBIC's have not been able to meet that demand. Figures derived from forms provided SBA by 345 SBIC's as of March 31, 1980.

There are additional reasons why SBA should act to address this situation. In this program, Government participation is Government debt, the amount of which is believed generally to produce adverse effects on the nation's economy. It would be nothing more than economically prudent for SBA to restrain or reduce that debt to the minimum necessary for the legitimate purposes of this program. At the very least, we believe that SBA should move to reduce idle funds, even should it decide to continue present leveraging practices.

Another reason for prompt action is that this program relies heavily on activities of the Federal Financing Bank which has been sharply criticized in a recent report on improving Federal credit management issued by the Office of Management and Budget. The report went so far as to urge dissolution of the Bank.[5] To the extent that SBA can reduce its Bank-related activities, it would advance this particular interest of the Administration.

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[4] We found that during the three-year period from April 1, 1977 to March 31, 1980, net idle funds in the SBIC program increased by $106 million while net SBA financing (leverage) increased concurrently by $136 million.

A final reason is that according to our estimates a significant portion, 65 percent, of the total idle funds is invested in the instruments of financial institutions.[6] Furthermore, of this amount, $140 million, or 28 percent, is invested in financial institutions related formally to the investment companies concerned. We are concerned at this development because the inherent incentives it creates tend to encourage inactivity and the maintenance of idle funds by SBIC's. In the case of the related institutions, these investments have the appearance of a conflict of interest and the potential incentives to inactivity are very strong.[7] While these types of investments are permitted by the regulations, we believe the Agency should curtail them as they confer no benefit whatever to small businesses and may only serve to prolong inactivity.

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[5] See, "Report on Strengthening Federal Credit Management," Volume II, Federal Financing Bank, pp. 19 and 29.

[6] These figures were extrapolated from a limited survey of the balance sheets of 49 SBIC's (of which 10 were MESBIC's) which were recently examined. Briefly, this survey disclosed that: 28 percent of idle funds was in certificates of deposit of related financial institutions (10 SBIC's); 37 percent was invested in certificates of deposit in unrelated financial institutions (34 SBIC's); and 28.8 percent was invested in Government instruments (21 companies).

[7] For example, one SBIC related to a major financial institution has $17 million in Government leveraging, reports $28 million in idle funds and has not made an investment for over three years.

In sum, we believe that SBA should develop and undertake two major efforts with respect to the SBIC program: (1) the reduction of the existing idle funds total and (2) the prevention of future growth in idle funds in this regulated industry. We believe both these efforts must begin with changes in the regulations and procedures which contributed to the current situation. We propose certain of such changes below. In addition, however, we are proposing that SBA consider a significant structural change in the system for investment to require SBIC's to make detailed representations and meet specific conditions before Government funds are advanced.

Recommendation One - Revise Leveraging Mechanisms

> Idle funds appear to us to accrue primarily in two ways: (1) through the receipt by investment companies of paid-back investments they have made for which no new investment opportunity is immediately available; and (2) through their retention of Government leveraging when planned investments fail to materialize. We offer several recommendations below to control the paid-back funds problem. Concerning the second problem, however, we propose that the Agency develop

an entirely revised leveraging mechanism along lines suggested by remarks contained in current instructions to investment companies applying for funding.

These current instructions to SBIC's applying for more than $1 million in funding require them to file an investment plan along with the request.[8] The purpose of this plan is to demonstrate to SBA that the funds will be invested. We believe that the very character of this investment plan, described as a "forecast" in the instructions, may well be the source of much of the idle funds buildup. Because it is merely a forecast of intentions, the investment plan can be ignored or modified drastically by an investment company without violating the terms of the funding and without having to return uninvested portions.

We propose that SBA consider changing to a system where leveraging is provided as an investment line of credit in place of current lump-sum methods of funding. The system we propose would require in the future that an SBIC notify SBA when 65 percent of its available capital has been invested in small business concerns and that it intends to apply for leveraging. Thereafter, the investment company would be granted a line-of-credit consistent with its eligibility, but no funds would be advanced.

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[8] See, "Memorandum of Instructions for SBIC Funding" dated April 1980, p. 6, which states in part, "Nothwithstanding the above, SBA reserves the right to require justification of a need for funds, with applications in lesser amounts, if a review of the applicant's idle fund position indicates a high cash position.

Once the investment company decides it needs any funding for a particular investment or series of investments, it would so notify SBA, specifying in detail the purpose of the request and the precise nature of its investment commitment. The investment company would also certify general compliance with regulations and specific compliance with enumerated significant regulations, such as those governing conflicts of interest. It is at this stage only of the leveraging transaction that investment companies would be permitted to request waivers of regulations, stating explicitly the rationale for the waiver.

The Investment Division would then review the examination findings and these formal representations by the investment company before advancing the requested funds from the line-of-credit. Within 60 days of funding the investment company would certify that it applied the funding in accordance with its request or, if it has not, it would return the unused remainder.

The regulations and procedures implementing this system change should clearly set forth all relevant criteria, forms, and definitions. They should carefully define the limits of the exercise of discretion by both the Agency and the investment company. The investment companies should be instructed unambiguously in the nature and importance of their representations in requesting funding. All Agency policy, such as criteria for granting waivers, should be explicitly described in these regulations.[9] No waivers of regulations should be granted after the fact unless based on a bona fide mistake by the licensee.

Despite the fact that this proposal would require significant changes in current operating methods, financing mechanisms with the Federal financing bank, and may generate considerable controversy, we believe that it is warranted by the size and nature of idle funds in this program. The proposed system would effectively preclude the future accretion of large amounts of idle funds derived from leveraging. It would also enhance the overall effectiveness of this Government financed program by improving controls over the use of proceeds. At the same time, the proposed system would create an audit "trail," an unambiguous record on which to base future criminal, civil, and regulatory enforcement actions for misrepresentations. All representations would be verified during annual examinations.

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[9] See, Administrative Procedure Act, 5 U.S.C. 552(a)(1)(D).

We estimate the burdens of administration of the proposed system on the Agency to be slight over present methods. The administration of this program is currently manual and centralized. If the burden of line-of-credit decisionmaking should prove greater than we estimate, our proposed system could be automated in part and easily decentralized to Region or District Offices. The advantages of our proposed system to the Government and the taxpayer in credit management are, we believe, obvious and substantial. The principal disadvantage to investment companies would be the difficulty in creating or maintaining idle fund balances from Government leveraging. In addition, investment companies would have to make firm commitments before Government funds are advanced. With proper administration, the Agency could easily advance requested funds within days of a request, making funds almost as accessible as they are currently.

In sum, we believe that the benefits of the proposed system far outweigh its foreseeable disadvantages. More importantly, however, the adoption of this system cannot be seen to threaten injury to small business nor to any investment company genuinely interested in investing in them.

Our recommendations concerning existing idle funds and inactivity follow.

Recommendation Two - Improve the Inactivity Regulation

The current inactivity regulation, 13 C.F.R. 1003, should be changed. We recommend that two distinct levels of regulation be designed in its place. The first level should set criteria to control the inactivity of SBIC's which are not leveraged by the Government, but do hold a license from the Agency. The criteria at this first level should be related entirely toward encouraging activity as a basis for retaining the SBIC license, consistent with the value of the license by itself.

The second level of regulation should establish activity criteria once an SBIC is leveraged. In these cases, because the licensee possesses Government leveraging, it should be required to make an affirmative showing of investment activity. The standard for inactivity at this level should be much more strict and detailed than at the first level, reflecting the fact of active Government participation.

Recommendation Three - Enforce Inactivity Regulations

Whether or not Recommendation Two, to improve the inactivity regulation, is adopted in the manner suggested, we urge that there be close enforcement of whatever inactivity rule is in effect. We so urge in the belief that it is not consistent with the purposes of the Small Business Investment Act for this agency to permit a licensee to remain in the program, retain borrowed Government funds, and earn profits thereby without incurring a correspondent risk of investment in small business concerns.

The high interest rates available today from investment of idle funds in Government and other securities create a powerful incentive not to risk these funds in small business investments. This incentive can only be overcome by the strict supervision of licensees and the certain sanctioning of those who violate the inactivity regulation.

Recommendation Four - Restrict Idle Funds Investment

At present, licensees are instructed by the regulations at 13 C.F.R. 107.808 to invest funds not needed for day-to-day operations in either Government instruments or instruments of financial institutions insured by Government agencies. We believe that this particular regulation has contributed to producing the sizeable balance in idle funds invested in financial institutions.

Moreover, we estimate that 28 percent or $140 million of the present balance of idle funds is invested in financial institutions which are related to the investing small business investment company. The benefit of these investments to such a related financial institution is considerable, including improvement of its deposits to loans ratio. Apart from inherent conflicts of interest, there would appear to be an incentive in these cases to retain idle funds and not aggressively to seek other investment opportunities.

We propose that this regulation be changed so as to require that funds above certain amounts not needed for day-to-day operations be invested only in Government instruments. This change would eliminate these potential conflicts of interests on the part of financial institutions, would marginally improve the security of idle funds, and would return to the Treasury the benefit of these amounts not needed for small business investment. It may happen at some future date, if this recommendation is adopted, that idle funds required to be invested in Government instruments will earn a lower return than if invested elsewhere. The net effect of such a situation, especially when coupled with strict enforcement of inactivity regulations (Recommendations 2 and 3) would be to discourage the retention of idle funds by licensees and would reinforce in licensees the incentive to seek small business investments as intended by the Small Business Investment Act. Moreover, in our opinion based on our experience in auditing and investigating this industry, a requirement to maintain idle funds only in Government instruments would render impractical most of the fraudulent, capital manipulation schemes we now encounter.

Recommendation Five - Eliminate The Idle Funds Balance

We believe that the large idle funds balance represents the current excess capacity for investment of the SBIC industry as a whole. We further believe that it is not fiscally prudent for the Agency to continue to leverage the industry as a whole without concurrently acting vigorously to reduce the idle funds balance. Moreover, we believe that the agency should move firmly against leveraged SBIC's with idle funds by acting to reduce the amount of the leveraging. While we do not underrate the complexity and difficulty of this endeavor, we believe that the sizeable sums now idle, equal to one-half of the present Government leveraging, make it worthwhile.

It may actually be possible for $300 to $500 million in Government leveraging to be eventually withdrawn from this program. Should it prove impractical to do so, however, the pressure by the agency to reduce the idle funds balance will directly assist those small businesses in which SBIC's will necessarily invest their excess capacity to avoid sanctions.

We recommend that an action plan be prepared and implemented as soon as possible with a goal of reducing the idle funds balance to the maximum extent possible in FY 1982 and again in succeeding fiscal years.

INVESTIGATION

of

SOUTHERN INVESTMENT AND FUNDING CORP. INC.
ATLANTA, GEORGIA
(LICENSE NUMBER 04/04-5133)

SMALL BUSINESS ADMINISTRATION
1953

OFFICE OF INSPECTOR GENERAL

OFFICE OF FINANCIAL INVESTIGATIONS
AND EXAMINATIONS

NOVEMBER, 1979

"For Internal Use Only"

77-52

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Al 103
5/19/80

Date: MAY 15 1980

To: See Distribution Below

From: Michael K. Casey
Associate Administrator
for Investment

Subject: Loan Administration Conference
Southern Investment and Funding Corp., Inc.
License No. 04/04-5133

Enclosed is a profile on the subject 301(d) Licensee which the Investment Division is desirous of placing in a liquidation status, and of a proposed letter to be sent to the Licensee.

In accordance with applicable procedures there will be a conference regarding the Licensee in my office at 10:00 A.M. on May 20, 1980.

We would appreciate it if you or your representative would be in attendance at that meeting.

/s/ Michael K. Casey
Michael K. Casey
Associate Administrator
for Investment

Enclosure

Distribution

E. T. Holloway, Director, Office of Portfolio Management
R. B. Webber, Associate General Counsel, Litigation
~~R. F. Randolph~~, Assistant Inspector General, ~~Audits~~ I
RRR

↑ to Marvin

R 5/19/8
784(

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Date:

To: Michael K. Casey
Associate Administrator
for Investment

From: Regions III and IV
Office of Investment

Subject: Southern Investment and Funding Corp., Inc.
Atlanta, Georgia
License No. 04/04-5133

1. Licensee

Southern Investment and Funding Corp., Inc.
300 W. Peachtree St., N. W.
Atlanta, Georgia 30308

2. Organization & Management

(a) Licensed on October 26, 1977
Private Capital - $500,000
3% Pfd. Stock Issued to SBA on 11/14/77 - $500,000
5 1/2% - 8 1/2% Debentures Issued to SBA on 7/26/78 - $500,000

(b) Officers, Directors & Shareholders

George Eng - President, Director - 100% Shareholder
Anne C. Eng - Secretary, Treasurer, Director
Donald Eng - Vice President, Assistant Secretary, Director

3. Financial

The latest Annual Report, SBA Form 468, filed by the Licensee is as of December 31, 1978, and reflects the following:

Assets

Cash & Idle Funds -	$ 205,039
Loans & Investments -	1,176,646
Other Assets -	61,806
	$ 1,443,491

Liabilities & Capital

Liabilities	$ 521,122
Private Capital	500,000
Preferred Stock Issued to SBA	500,000
Retained Earnings Deficit	(77,631)
	$ 1,443,491

4. Operations and Compliance

On January 9, 1979, the Investment Division requested that an examination be made of the Licensee in connection with its application for leverage.

On March 22, 1979, an examination report was issued by the Compliance Audit Division which cited violations of Section 107.1105(a) - failure to report total operating expenses; and Section 107.803 - activities not contemplated by the Act. This latter finding ultimately resulted in an investigation of the Licensee, and an Investigation Report issued in November 1979, recommended "...that immediate action be taken to remove this Licensee from the Small Business Investment program and that the Licensee be required to return all Government funds as soon as possible."

The Investment Division sent a copy of the Investigation Report to the Office of Litigation, OGC, on December 27, 1979, with a request that OGC advise whether the Report disclosed any regulatory violations which might serve as a basis for civil action by SBA.

5. Default on Interest Payment to SBA:

On January 14, 1980, and again on February 11, 1980, the SBA sent "Notice of Loan Payment Past Due" to the Licensee with respect to the interest payment of $13,750 which was due on its Debenture No. 04/04-5133. To date we have failed to receive the payment due, or any other word from the Licensee on this matter.

As provided for under Section 107.203(b) of the Regulations, the Investment Division recommends that the entire indebtedness of the Licensee to the SBA be declared immediately due and payable to the SBA.

Note:

The Licensee's Annual Report, SBA 468, as of December 31, 1979, which was due to be filed by March 30, 1980, has not yet been received by the SBA.

Milton A. Ganas /for
Anthony DiMuzio
Chief, Regions III and IV
Office of Investment

4/16/80
File

CLEARED:

Marvin P. Shelton
Marvin P. Shelton, Director

JKR
OFI:JKReeves:tj 4/15/80

APR 16 1980

Peter F. McNeish
Deputy Associate Administrator
for Finance and Investment

Office of Inspector General AIG/I (79-52)

Southern Investment and Funding Corp, Inc.
License No. 04/04-5133

We have contacted the United States Attorney's office on your request of February 12, 1980, and subsequent request of March 18, 1980.

Mr. Howard J. Weintraub, Assistant U.S. Attorney, FTS phone 242-4230, stated that he had no objections to SBA taking civil action to protect the Government's interest in this case.

Please telephonically contact Mr. Weintraub to discuss the proposed action prior to initiation of the action.

Should you have any questions, please contact me.

R.R. Reusche
Assistant Inspector General
for Investigations

cc: Office of General Counsel
Attn: Office of Litigation

Rec'd
12/10/79
F.12

DEC 7 1979

Peter F. McNeish
Acting Associate Administrator
for Finance and Investment

Office of Inspector General/AIG/I

Southern Investment
and Funding Corporation, Inc.
Atlanta, Georgia
License No. 04/04-5133

Attn: Director, Office of Investment

Enclosed are two copies of the investigation report on the subject firm. A set of exhibits supporting the information contained in the report are maintained in the Office of Financial Investigations and Examinations.

The report indicates a possible conspiracy by George Eng, Jimmy D. NeSmith and others to obtain a license as a Small Business Investment Company and $1,000,000 of leverage funds from SBA. Mr. Eng claims to have invested $500,000 in unencumbered funds into the firm. This investment was not made. To conceal this fact, Mr. Eng and others devised a scheme and artifice to defraud and deceive SBA whereby a license and money were obtained by means of false and fraudulent representations. To accomplish this scheme, funds were disbursed to various small business concerns in a circular manner and were returned by the small business concerns and redeposited to the licensee's checking account. The possible conspiracy caused the making of various false statements to SBA and various false entries in the licensee's books and records.

The report shows three other cases which indicates possible conspiracy on the part of Mr. Eng, David Young, Richard Tanaka, Donald Eng, Kenneth Eng, and others to obtain funds from the licensee which for the most part, were for the personal use of Mr. Eng or the benefit of corporations owned or controlled by him. A reported financing to Restaurant Specialists Associates, Inc. (a passive company) was used solely as a conduit for diverting funds from the licensee for unauthorized purposes. Proceeds from the reported financing to Atlantic Capital Corporation, were used for the benefit of corporations owned/or controlled by Eng. Purported financing to Lights & Locks indicate a legitimate loan, however, proceeds from the loan were used for the benefit of individuals associated with Mr. Eng. Entries were made on the licensee's books and records showing that Lights & Locks had repaid the loan when, in fact, licensee funds were diverted through another small business concern and used for this purpose.

The report indicates that Mr. Eng, either made or caused to be made various false and misleading entries on the licensee's books and records, prepared or caused to be prepared false or misleading loan documentation in order to conceal the misuse of licensee funds and the fact that no private capital was invested into the licensee by its principals.

Also, the report indicates a possible conspiracy by Mr. Edwin Baker and Mr. Dean Benshoff to use Greater Americas Corporation, Inc., as a conduit to obtain funds from the licensee which were used for the benefit of various individuals and other corporations with which the two men are associated. In addition to the above, there were five Regulatory violations that included three Conflicts of Interest: One Prohibited use of Funds and one False Filing made to SBA.

We recommend that immediate action be taken to remove this Licensee from the Small Business Investment program and that the Licensee be required to return all government funds as soon as possible. However, no civil action should be taken without coordinating with the United States Attorney's Office in Atlanta.

A copy of the report and a copy of this memorandum are being sent to the United States Attorney's Office in Atlanta, for whatever action he deems appropriate.

Please advise this office within 30 days of the action taken or contemplated to be taken on this report.

Should you have any questions or if this office can be of further assistance, please let me know.

R. R. Reusche
Assistant Inspector General
for Investigations

Enclosures

cc: United States Attorney
Atlanta, Georgia

AIG/A (ORA)

CLEARED:

Marvin P. Shelton
Marvin P. Shelton, Director
FIE

FIE: [illegible]Foreman:aj 12/3/79

[illegible]
File

DEC 7 1979

Honorable William Harper
United States Attorney
Room 428, U.S. Courthouse
56 Forsyth Street
Atlanta, Georgia 30303

Attention: Mr. William Toliver
Assistant U.S. Attorney

Re: Southern Investment
and Funding Corporation
Atlanta, Georgia

Dear Mr. Harper:

Enclosed is a copy of the investigation report on the subject firm. We are also sending under separate cover, the exhibits which contain the documentation to support the findings.

As discussed with Mr. William Toliver, by a member of my staff, the report indicates several instances of possible conspiracies by Mr. George Eng and others; possible false statements; possible filing of false, fictitious claims; possible misapplication of funds and possible conversion of funds. Mr. Eng, claims to have invested $5000,000 in unencumbered funds into the firm. This investment was not made. To conceal this fact, Mr. Eng and others devised a scheme and artifice to defraud and deceive SBA whereby a license and money were obtained by means of false and fraudulent representations. Financial records were falsified and fictitious loans were made to various small business concerns and the proceeds were returned to subject firm which in several instances, were diverted for the personal use of Mr. Eng and/or his associates.

For your information, we are enclosing a copy of our transmittal memorandum to SBA's Associate Administrator for Finance and Investment, informing him of our referral of this case to your office for whatever action you deem appropriate.

Should you have any questions or if this office can be of further assistance, please let me know.

Sincerely,
R. R. Reusche

R. R. Reusche
Assistant Inspector General
for Investigations

Enclosures

cc: AA/FI

AIG/A (ORA)

CLEARED:

Marvin Shelton
Marvin P. Shelton, Director
FIE

FIE:JBForeman:aj 11/30/79

ATTENTION

Action taken or to be taken on the information contained in this report must be reported to the Office of Inspector General within 30 days of the issue date of the report.

This investigation/examination was made in accordance with the policies and procedures contained in SOP 90 22 2.

Information contained in this report is to be disclosed only to responsible SBA personnel on a "need to know" basis. Disclosure of information to other than SBA personnel must not be made without the approval of the Inspector General and may only be done in compliance with the Freedom of Information Act (5 U.S.C. 552), and the Privacy Act of 1974, where applicable, as implemented by Agency policy, regulations, and SOP's (40 03, 40 04) and 18 U.S.C. 1905.

This report is issued by the Office of Financial Investigations and Examinations, OFFICE OF INSPECTOR GENERAL.

Approved:

Marvin P. Shelton, Director,
Office of Financial Investigations
and Examinations

Date DEC 7 1979

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REPORT ON INVESTIGATION
OF
SOUTHERN INVESTMENT AND FUNDING CORPORATION, INC.
Atlanta, Georgia
(License Number 04/04-5133)

INTRODUCTION AND SCOPE

The Office of the Inspector General, Office of Financial Investigations and Examinations, made an investigation of Southern Investment and Funding Corporation, Inc. (Southern Investment). The purpose of the investigation was to determine whether Southern Investment or persons associated with the licensee had violated provisions of the Small Business Investment Act of 1958 and/or regulations relating to the Act. By letter dated May 2, 1979, the Director, Office of Investment Division, specifically requested that the particulars of a financing made by Southern Investment to Restaurant Specialists Associates, Inc. be reviewed. The investigation was conducted pursuant to authority set forth under Section 310(a) of the Small Business Investment Act.

The investigation included a review and analysis of SBA operation files on the licensee, a review of books and records of Southern Investment, and interviews with principals of Southern Investment and portfolio small business concerns. The investigation also included interviews with various bank officials and other third parties knowledgeable of the operations of Southern Investment or small business concerns.

As of April 30, 1979, Southern Investment had made 20 separate financings to small business concerns of which 11 were selected for detailed review. The 11 small business concerns were visited and, to the extent that records could be obtained, proceeds from the financings were traced to determine the eventual use of the funds.

In-depth interviews were not conducted with Southern Investment officials. Mr. George Eng, Southern Investment's President and sole stockholder, requested that all questions resulting from the investigation be submitted to him in writing. A list of questions was provided Mr. Eng on September 24, 1979, and his response was received on October 23, 1979. Information provided by Mr. Eng has been included in this report where appropriate.

Results of the investigation have been discussed with an Assistant United States Attorney for the Northern District of Georgia. The Assistant United States Attorney has indicated that the Department of Justice will consider prosecution.

SUMMARY

Mr. George Eng may have conspired with Mr. Jimmy D. NeSmith and others to obtain a license as a 301(d) Small Business Investment Company (MESBIC) and $1,000,000 of leverage funds from SBA. The license was issued to Southern Investment and funds advanced based on Mr. Eng's claim that he had invested $500,000 into Southern Investment and that the corporation had unencumbered private paid-in capital of that amount in a certificate of deposit. The initial $500,000 investment was not made by Mr. Eng as claimed and the certificate of deposit balance was overstated by $500,000. To conceal this fact, funds were disbursed to various small business concerns and used in a circular financing scheme whereby monies were returned by the small concerns and redeposited to Southern Investment's checking account. In this regard, various false entries were made in the licensee's books and records in that the disbursements were recorded as loans and/or stock purchases and the deposits were recorded as reductions to the certificate of deposit balance. Also, various possible false statements were made to SBA by Messrs. Eng and NeSmith and an endorsement on a $75,000 check was apparently forged. Mr. NeSmith is President of the First American Bank which benefited from various financings made by Southern Investment. Other possible conspirators include Mr. Donald Eng who was responsible for the licensee's accounting functions and Messrs. Leonard Hsu, Wilhelm Williams, and E. C. Pemberton. The latter individuals were recipients of proceeds from various financings which were returned to Southern Investment.

Mr. Eng may have conspired with Mr. David Young and others to use Restaurant Specialists Associates, Inc., as a conduit for obtaining licensee funds for personal and other unauthorized uses. Of the total funds disbursed, $105,850 appears to have been received by Mr. Eng personally, $18,000 was deposited into the account of Eng Enterprises, $2,075 was returned to Southern Investment, and $10,000 was disbursed to Mr. Eng's sister. The investigation disclosed no indication that the small business concern is actively engaged in business activities and, as such, appears to be a passive corporation which was used solely as a conduit for diverting funds from the licensee for unauthorized purposes. In this regard, various loan documents were falsified and an endorsement on a $2,075 check was apparently forged.

Mr. Eng may have conspired with Mr. Richard Tanaka and others to divert funds from the licensee for unauthorized purposes. In this regard, entries were made in the licensee's books and records and various loan documents were prepared indicating that a legitimate financing had been made to Atlantic Capital Corporation. Proceeds from the financing to the small business concern were used for the benefit of corporations owned and/or controlled by Mr. Eng. Other possible conspirators include Messrs. Donald and Kenneth Eng. Donald Eng was responsible for the licensee's accounting functions and Kenneth Eng signed checks on an account of a corporation owned by Mr. Eng which were used for unauthorized purposes. Both Donald and Kenneth Eng are sons of George Eng.

Mr. Eng may have conspired with various other individuals to divert funds from the licensee for unauthorized purposes and to falsify records of the licensee in order to conceal the misuse of funds. In this regard, various loan documents were prepared and entries made in the licensee's books and records to indicate that a legitimate financing had been made to Mr. and Mrs. Donald Macleod, d/b/a Lights & Locks. Proceeds from the loan were used to benefit individuals with whom Mr. Eng was associated. Entries were also made in the licensee's books and records showing that the loan was repaid by principals of Lights & Locks when, in fact, licensee funds were diverted through another small business concern and used for this purpose.

Mr. Eng made a possible false statement to SBA in the license application regarding compensation paid to Interamerican Marketing Association for assistance provided to him in the formation of Southern Investment and processing the license application. Although documentation was provided to SBA showing that no fees were paid to Interamerican Marketing, the investigation disclosed that funds totaling $20,000 which were provided to the licensee by SBA were disbursed to the firm shortly after the initial funding was received from SBA. In addition, Interamerican Marketing and/or its principals received proceeds totaling $113,637 from a financing made by Southern Investment to Greater Americas Corporation, Inc.

Mr. Edwin Baker may have conspired with Mr. Dean Benshoff and possibly others to use Greater Americas Corporation, Inc. as a conduit for obtaining licensee funds in the amount of $150,000. The funds advanced by the licensee were generally used to benefit various individuals and/or other corporations with which Messrs. Baker or Benshoff were associated. In this regard, documentation was supplied to the licensee showing that the small concern had incurred a $90,000 obligation to Maryland Medical Supply, Inc. for the purchase of used medical equipment valued in excess of $111,000. The investigation disclosed that the equipment had a value substantially less than the amount represented and that aspects of the obligation incurred by the small concern to Maryland Medical were questionable. The investigation disclosed nothing to indicate that Greater Americas or Maryland Medical were actively engaged in business activities and, as such, appear to be passive corporations which were used to obtain funds from the licensee for use by other corporations and/or individuals.

Proceeds totaling $46,000 from a financing made to Angelia Vending Machine, Inc. were used to repay a loan made by the licensee to another small business concern. The licensee's accounting records indicate that the amount was owed by Angelia Vending for a brief period of time after the funds were returned by the small business concern in December 1978. Although the loan balance was subsequently reduced on the licensee's records as a result of a $46,000 deposit made in January 1979, the investigation disclosed that the funds deposited were provided by the licensee's President, Mr. George Eng. This action was apparently the result of an attempt on the part of Mr. Eng to conceal the misuse of funds which were provided by the licensee to Lights & Locks.

Southern Investment provided financing to Pemco Fruit, Inc. in the amount of $150,000. Of the total financing, $75,000 was classified as a loan and $75,000 was represented to be a purchase of 400 shares of stock in the small concern. Proceeds from the sale of stock to Southern Investment were returned to and deposited into the account of the licensee. The receipt of the $75,000 was erroneously recorded in the licensee's books and records as a transfer of funds from certificates of deposit in an attempt to conceal that no private capital was invested into the licensee by its principals. Loan proceeds totaling $5,999 were used to repay personal indebtedness of Pemco Fruit principals. Other proceeds from the loan were used for business related purposes including $62,200 which was paid to the First American Bank for land and equipment purchased by Pemco Fruit.

Southern Investment provided financing to New WAVE, Inc. in the amount of $150,000. Of the total financing, $145,000 was returned to the licensee and no reduction made in the loan balance as recorded in the licensee's books and records. The funds appear to have been redeposited into the licensee's account and recorded as a transfer of funds from certificates of deposit in an attempt to conceal that no private capital was invested into the licensee by its principals. The use of other loan proceeds could not be verified due to the unavailability of records.

Southern Investment provided financing to Overseas Homes, Inc. in the amount of $127,500. Of the total financing, $102,500 was classified as a loan and $25,000 was represented to be a purchase of common stock in the small business concern. Of the $127,500 advanced to Overseas Homes, $100,000 was returned to and deposited into the account of the licensee. Receipt of the $100,000 was erroneously recorded in the licensee's books and records as a transfer of funds from certificates of deposit in an attempt to conceal that no private capital was invested into the licensee by its principals. In this regard, an endorsement on a $75,000 check issued from Overseas Homes' account to Mr. Richard Huff was apparently forged. Also, Dr. Leonard Hsu, President of Overseas Homes, submitted a possible false statement to SBA auditors which substantially overstated the small concern's indebtedness to the licensee. The balance of proceeds advanced to Overseas Homes ($27,500) appears to have been used for business related purposes of the small concern.

Proceeds totaling $34,432 from the $45,000 financing made to Bulloch Ventures, Inc. were used to refinance a loan owed by the small concern to the First American Bank of Warm Springs. Based on the results of the investigation, it appears as though the licensee's financing was made as an accommodation to the bank. Although a complete verification was not made of the balance of the proceeds from the loan, the funds were generally advanced to officers of the small business concern or used for working capital and related business costs. A $1,350 disbursement was made from the proceeds of the loan to Southern Investment and classified as a loan discount fee. The investigation disclosed that the $1,350 fee was not deposited into the licensee's operating account.

Proceeds from a $55,000 financing made to Consumer Mart International, Inc. were not used for authorized purposes or as contemplated. Licensee officials were aware of the misuse of proceeds and have initiated action to protect the licensee's interests in this regard.

Proceeds from an $88,818 financing made to Gallery Construction Company, Inc. were used as authorized. Of the total funds advanced to the small business concern, $37,818 was used for working capital and $51,000 was paid to the First American Bank and/or its officials for equipment purchased and debt repayment.

RECOMMENDATION

It is recommended that immediate action be taken to remove this Licensee from the Small Business Investment program and that the Licensee be required to return all government funds as soon as possible.

BACKGROUND

Southern Investment and Funding Corporation, Inc. was chartered under the laws of the State of Delaware on June 13, 1977. It was established for the purpose of operating solely as a licensee under the Small Business Investment Act of 1958, as amended.

On July 5, 1977, Southern Investment applied for a Small Business Investment Company license under Section 301(d) of the Small Business Investment Act. The application was approved on October 26, 1977. SBA issued license number 04/04-5133 to the corporation on the same date.

On August 8, 1977, Southern Investment applied for funding from SBA in the amount of $500,000. On November 14, 1977, the application was approved and SBA purchased 500 shares of the corporation's $1,000 par value preferred stock. U. S. Treasury check number 52,775,388 in the amount of $500,000 was issued to Southern Investment on November 16, 1977 as payment for the stock. The stock was issued pursuant to Section 303(c) of the Small Business Investment Act of 1958 and requires cumulative dividends payable at the rate of seven and five-eighths percent.

On May 8, 1978, Southern Investment applied for additional funding from SBA in the amount of $500,000. The application was approved on July 26, 1978, and U. S. Treasury check number 59,238,373 was issued to the licensee on July 31, 1978. The debt is secured by a 10 year subordinated debenture. The debenture matures in July 1988 and provides for interest at a rate of five and one-half percent during the first five years and eight and one-half percent during the last five years of the effective debenture period.

Southern Investment began operations in November 1977 with reported private paid-in capital of $500,000. As of April 30, 1979, the licensee's records show that it had provided financing to 20 small concerns. Outstanding balances owed on financing made to small concerns on April 30, 1979, were as follows:

Amount Outstanding	Name of Small Concern	Type of Financing
$ 150,000	Greater Americas Corporation, Inc.	Preferred stock purchase
70,000	Atlantic Capital Corporation	Loan
400	Atlantic Capital Corporation	Common stock purchase
37,051	Consumer Mart International, Inc.	Loan
9,839	Moy's Garden, Inc.	Loan
44,541	Bulloch Ventures, Inc.	Loan
10,263	Lum Leog d/b/a Lumkee Restaurant	Loan
88,819	Gallery Construction Company, Inc.	Loan
10,672	Don Black Corporation	Loan
16,232	Giordano's of Riverdale	Loan
-0-	Lights & Locks, Inc. (Loan Repaid per records)	Loan
13,730	Mid-South Corporation, Inc.	Loan
150,000	New W.A.V.E., Inc.	Loan
38,837	KGY, Inc.	Loan
32,705	Angelia Vending Company, Inc.	Loan
500	Angelia Vending Company, Inc.	Common Stock Purchase
9,255	China House Corporation	Loan
75,000	Pemco Fruit Company, Inc.	Loan
75,000	Pemco Fruit Company, Inc.	Common Stock Purchase
102,500	Overseas Homes, Inc.	Loan
25,000	Overseas Homes, Inc.	Common Stock Purchase
90,000	Restaurant Specialists Associates, Inc.	Loan
60,000	Restaurant Specialists Associates, Inc.	Common Stock Purchase
8,261	Nash Janitorial Contractors, Inc.	Loan
40,000	House of Fong, Inc.	Loan
$1,158,605	TOTAL OUTSTANDING	

On May 22, 1979, Southern Investment had 1,000 shares of $500 par value stock outstanding. The sole stockholder was Mr. George Eng. Also on May 22, 1979, Southern Investment's officers and directors were as follows:

Mr. George Eng - President/Director
Mr. Donald Eng - Vice President/Director
Mrs. Anne Eng - Secretary/Treasurer/Director

In addition to his ownership of Southern Investment, Mr. Eng is also the principal owner of Eng Enterprises, Inc. and Tara Memorial Gardens, Inc. Eng Enterprises, Inc. operates two Chinese restaurants in Atlanta, Georgia under the trade name "Trader Eng's". Tara Memorial Gardens, Inc. is actively engaged in the operation of a cemetery in Stockbridge, Georgia.

FINDINGS

Possible Conspiracy to Defraud SBA - Title 18 U.S.C. Section 371

Possible False Statements - Title 18 U.S.C. Section 1001 and 1006 and Title 15 U.S.C. Section 645(a)

Possible Filing of False, Fictitious or Fraudulent Claims - Title 18 U.S.C. Section 287

Possible Misapplication of Funds - Title 18 U.S.C. Section 657

Possible Conversion of Funds - Title 15 U.S.C. Section 645(c)

Use of Funds for Prohibited Purposes - Section 107.1001

Conflict of Interests - Section 107.1004(a) and (b)

False Filings Made to SBA - Section 107.1008

Mr. George Eng may have conspired with Mr. Jimmy D. NeSmith and others to obtain a license as a 301(d) Small Business Investment Company (MESBIC) and $1,000,000 of leverage funds from SBA. The MESBIC license was issued to Southern Investment and funds advanced based on Mr. Eng's claim that he had invested $500,000 into Southern Investment and that the corporation had unencumbered private paid-in capital of that amount in a certificate of deposit. The initial $500,000 investment was not made by Mr. Eng as claimed and the certificate of deposit balance was overstated by $500,000. To conceal this fact, funds were disbursed to various small business concerns and used in a circular financing scheme whereby monies were returned by the small concerns and redeposited to Southern Investment's checking account. In this regard, various false entries were made in the licensee's books and records in that the disbursements were recorded as loans and/or stock purchases and the deposits were recorded as reductions to the certificate of deposit balance. Also, various possible false statements were made to SBA by Messrs. Eng and NeSmith and an endorsement on a $75,000 check was apparently forged. Mr. NeSmith is President of the First American Bank which benefited from various financings made by Southern Investment. Other possible conspirators include Mr. Donald Eng who is responsible for the licensee's accounting functions and Messrs. Leonard Hsu, Wilhelm Williams, and E. C. Pemberton. The latter individuals were recipients of proceeds from various financings which were returned to Southern Investment.

Title 18 U.S.C. Section 371 states that if two or more people conspire to commit any offense against the United States, defraud the United States or any Agency thereof in any manner or for any purpose and one or more such persons do any act to effect the object of the conspiracy they may be fined or imprisoned or both. Title 18 U.S.C. Section 2 states that whoever commits an offense against the United States, or aid; abets, conceals, commands, induces, or procures its commission, is punishable as a principal and whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

Title 18, U.S.C. Section 1001 states that whoever, in any manner within the jurisdiction of any Department of Agency of the United States, knowingly and willfully, falsifies, conceals, or covers up by any trick, scheme, or device, a material fact or makes any false, fictitious or fraudulent statement or presentation or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, may be fined, imprisoned, or both.

Title 15 U.S.C. Section 645(a) states that whoever makes any statement knowing it to be false for the purpose of influencing in anyway the action of the Small Business Administration, or for the purpose of obtaining anything of value under this Act, shall be subject to a fine or imprisonment or both.

Title 18 U.S.C. Section 1006 provides that whoever knowingly makes any false entry in the books and records of any Small Business Investment Company with the intent to defraud may be fined, imprisoned, or both.

Title 18, U.S.C. Section 287 states that whoever makes or presents to any civil department or agency any claim upon or against the United States or any department thereof knowing such claim to be false, fictitious or fraudulent could be fined or imprisoned or both. The Supreme Court of U.S. vs. Neifest-White Co., 390 U.S. 228 (1967) interpreted the False Claims Act to apply to the supplying of false information in support of a loan application.

Title 18, U.S.C. Section 657 states that whoever being an officer, employee, or connected in any capacity with any Small Business Investment Company, and whoever being a receiver of such institution, embezzels, abstracts, purloins or willfully misapplies any money, funds, credits, or securities or other things of value belonging to such institution, or pledged or otherwise entrusted to its care, could be fined, imprisoned, or both.

Title 15, U.S.C. Section 645(c) states that whoever, with intent to defraud, knowingly disposes or converts to his own use or to that of another, any property mortgaged or pledged to the administration, shall be fined or imprisoned or both.

Section 107.1001 of SBA regulations state that no funds may be provided to a small concern directly or indirectly, for purchasing stock in or otherwise providing capital for a licensee, or to repay an indebtedness to accomplish such purpose.

Section 107.1004(a) of the SBA regulations provide that self-dealing to the prejudice of the small concern, or of a corporate licensee or its shareholders, or of SBA, is prohibited.

Section 107.1004(b) of SBA regulations provide that, except where a written exemption may be granted by SBA in special instances, a licensee shall not directly or indirectly provide financing to any of its associates.

Section 107.1008(b) of SBA regulations state that any false statement knowingly made, or misrepresentation or failure to state a material fact necessary in order to make a statement not misleading in the light of the circumstances under which the statement was made, in any document submitted to SBA shall constitute a violation of these regulations.

Southern Investment's application for license was submitted to SBA in July 1977. The application shows that the corporation had $500,000 private paid-in capital and paid-in surplus arising from the sale of 1,000 shares of $500 par value common stock to Mr. George Eng and that no borrowed funds were used for the purchase of the stock. Also included in the application was a letter dated June 6, 1977, from Mr. Jimmy D. NeSmith, President of First American Bank of Warm Springs, Georgia. The letter states:

> "We have available the sum of $500,000.00 to the credit of Southern Investment and Funding Corporation, Inc. We understand that Southern Investment and Funding Corporation, Inc. has applied for a license as a Section 301(b) SBIC.
>
> Our instructions are to deliver a certified or cashiers check to First American Bank payable to Southern Investment and Funding Corporation, Inc. upon the completion by SBA of the following:
>
> 1. Issue a comment letter on the application and
>
> 2. Publish notice of the application filing in the Federal Register.
>
> Upon completion of the above stated events, such certified or cashiers check in the sum of $500,000.00 in proceeds shall be deposited directly in the account of Southern Investment and Funding Corporation, Inc., First American Bank, at which time the funds will be held without encumbrance or restriction."

In August 1977, Mr. Eng submitted an application for the sale of $500,000 preferred stock to SBA. The application contained a financial statement showing that Southern Investment had cash on hand of $500,000 on August 8, 1977. Also included in the application was a letter from the First American Bank dated August 9, 1977. The letter, which was signed by Mr. NeSmith, states:

> "...As of this date, there are funds available in the amount of $500,000.00. These funds are held without encumbrance or restriction by this bank."

In October 1977, SBA approved Southern Investment's license application. License 04/04-5133 was issued to Southern Investment on October 26, 1977. The application for the sale of preferred stock was approved by SBA in November 1977. A $500,000 U. S. Treasury check was issued to Southern Investment on November 16, 1977, to purchase the stock.

In May 1978, Mr. Eng submitted an application to SBA for the sale of a $500,000 subordinated debenture. Included as part of the application was a financial statement on Southern Investment's operations for the period ending March 31, 1978. The financial statements show that Southern Investment had invested idle funds of $500,000 consisting of a certificate of deposit issued by the National Bank of Georgia.

On July 26, 1978, SBA approved the application for the sale of the debenture and issued a $500,000 U. S. Treasury check to Southern Investment on July 31, 1978.

On October 1, 1977, the First American Bank loaned Mr. George Eng $500,000 on a 30 day term note. The proceeds from the loan were used to purchase a certificate of deposit from the bank on the same date. On November 2, 1977, the certificate of deposit was redeemed and the proceeds used to repay Mr. Eng's debt to the bank. According to

Mr. NeSmith, this was done in accordance with Mr. Eng's instructions.

According to the manager of the First American Bank's branch in Luthersville, Georgia, the bank's legal lending limitation was about $78,000 at the time the loan was made to Mr. Eng. Thus, the loan exceeded the bank's lending limitation by approximately $422,000. The bank official advised that occasionally loans were made which exceeded the lending limitation if a customer had a certificate of deposit or other cash items in the bank securing the loan.

On November 25, 1977, Mr. Eng obtained a $500,000 loan from the National Bank of Georgia and used the proceeds to purchase a certificate of deposit from the bank. The loan was made by the bank at the request of and as an accommodation to Mr. NeSmith. The loan was secured by Mr. NeSmith's personal guaranty. The note matured on December 9, 1977, at which time, the certificate of deposit was cashed and the proceeds used to repay Mr. Eng's debt to the bank.

During this approximate period of time, Southern Investment's application for the sale of preferred stock was being considered by SBA.

Correspondence in the bank's files show that the loan was made in connection with the licensee's application to SBA and that the loan would be repaid with proceeds from the certificate of deposit. A November 28, 1977,memorandum to the file from a Senior Vice President of the National Bank of Georgia explained the loan as follows:

> "We have booked a $500,000 loan for George Eng which will mature on 12/9/77 and carry a rate of 10.75. The loan is unsecured with a separate guarantee from J. D. NeSmith. The proceeds were used to purchase a non-interest CD in the name of Southern Investment

> and Funding Corporation, Inc., which we are holding but it is not pledged. Southern Inc. of which Eng is President, is obtaining a $2,000,000 government loan under its minority program (MESBIC) and needed the temporary increase in the company's financial structure to qualify for this loan. This CD also matures on 12/9 and proceeds will be used to pay the loan off."

On March 27, 1978, Mr. Eng again borrowed $500,000 from the National Bank of Georgia based on the personal guarantee of Mr. NeSmith. The proceeds from the loan were also invested in a certificate of deposit issued by the Bank. The note matured on May 8, 1978, at which time, the certificate of deposit was redeemed and the note repaid. During this approximate period of time, Mr. Eng submitted the application to SBA for the sale of the subordinated debenture.

By journal entry dated December 31, 1977, general ledger accounts were established in the records of Southern Investment showing that $500,000 was available in a time certificate of deposit and common stock was purchased providing the source of funds for purchasing the certificate. The records indicate that the funds remained in the certificate of deposit until August 1978 at which time the account balance was increased by $300,000 from proceeds received from SBA's purchase of the subordinated debenture. Between the period August through December 1978, the entire $800,000 was credited out of the account. No additional transactions were posted to the account subsequent to December 31, 1978, and the records reflected a zero balance at the completion of the investigation. Reductions to the account balance were made as follows:

August 1978	$150,000
September 1978	150,000
October 1978	250,000
November 1978	100,000
December 1978	150,000
TOTAL	$800,000

Deposits totaling $700,000 were made to the account of Southern Investment and classified as reductions to the certificate of deposit balance. The additional $100,000 discrepancy represents a November 1978 transaction for which no deposit was made. This matter was not resolved. Deposits reflected as reductions of the certificate of deposit balance were as follows:

August 15, 1978	$150,000
September 29, 1978	150,000
October 3, 1978	25,000
October 20, 1978	75,000
October 30, 1978	150,000
November 1978	-0-
December 15, 1978	150,000
TOTAL	$700,000

Regarding the source of funds deposited to Southern Investment's account and represented to be reduction of the certificate of deposit balance, the investigation disclosed the following:

- The $150,000 deposited to the account on August 15, 1978, represented a transfer from the First American Bank of Warm Springs, Georgia to the bank's branch office in Luthersville, Georgia where the Southern Investment account is maintained.

On August 17, 1978, a $145,000 check was paid from Southern Investment's account and transacted at the First American Bank. The check was issued payable to The New W.A.V.E. (USA), Inc. (New WAVE) and endorsed by Mr. Wilhelm A. Williams for the small business concern. Southern Investment's records reflect that the check was issued as part of a $150,000 loan to the small concern.

Mr. Williams, Chairman of the Board of New WAVE verified his endorsement on the check but stated that it was returned to Southern Investment at Mr. Eng's request. According to Mr. Williams, New WAVE has received financing from and owes Southern Investment $10,000 in lieu of $150,000 as reflected in the records of Southern Investment. Mr. Vinod Vasudeva, President of New WAVE, also stated that the $145,000 check was returned to the licensee.

Although the investigation did not specifically identify the disposition of proceeds from the $145,000 check, it appears that the funds were used as a part of the $150,000 deposit made to Southern's account on August 15, 1978.

Additional information concerning the financing to New WAVE is included in a separate section of this report.

- The $150,000 deposit made to the account of Southern Investment on September 29, 1978, represented proceeds from a 30 day term loan obtained from the First American Bank in Warm Springs, Georgia. The loan was secured by a $300,000 certificate of deposit which was purchased on August 1, 1978, by Southern Investment from proceeds received from the debenture sale to SBA. The certificate was cashed on October 30, 1978, and the note repaid.

- The $25,000 deposit made on October 3, 1978, represented the redeposit of a Southern Investment check issued payable to Overseas Homes, Inc. (Overseas Homes). The $25,000 check was disbursed to Overseas Homes on August 31, 1978, and recorded in the books of Southern Investment as a partial disbursement of a $150,000 loan to the small concern.

Dr. Leonard Hsu, President of Overseas Homes, advised that the $25,000 check was received by him and returned to Mr. Eng. According to Dr. Hsu, Mr. Eng cashed the check and gave him $25,000 in cash. Dr. Hsu stated that he converted the cash to Taiwan currency and hand carried the funds to Taiwan where it was invested into one of his corporations in Taiwan.

The Cashier of the First American Bank traced the transaction and found that the check was not cashed as stated by Dr. Hsu and that the funds were redeposited to Southern Investment's account.

Additional information regarding the financing to Overseas Homes is included in a subsequent section of this report.

- The $75,000 deposit made on October 20, 1978, represented proceeds of a check issued on the account of Pemco Fruit, Inc. (Pemco Fruit) payable to cash.

By check dated October 3, 1978, Southern Investment disbursed $75,000 to Pemco Fruit as part of a $150,000 financing to the small business concern. The total financing was recorded in Southern Investment's records as a loan and stock purchase of $75,000 each.

The $75,000 check was deposited into Pemco Fruit's account with the First American Bank on October 20, 1978. Also on October 20 a $75,000 check was issued and paid from the account of Pemco Fruit and deposited into Southern Investment's account at the same bank.

Mr. E. C. Pemberton, President of Pemco Fruit, denied that any of the proceeds from the financing received from Southern Investment were returned to either Southern Investment or Mr. Eng. However, Mr. Pemberton could not explain the transaction.

Mr. Charles Williams, a certified public accountant who handles Pemco Fruit's accounting functions, advised that he had attempted to resolve the question of the $75,000 check with Mr. Pemberton. On June 29, 1979, Donald Eng endorsed the stock certificate back to Mr. Pemberton which had previously been provided to Southern Investment to evidence its stock purchase in Pemco Fruit. According to Mr. Williams, this was done to correct the $75,000 discrepancy in Pemco Fruit's account which resulted when the $75,000 check was issued from the account.

Additional information regarding the financing to Pemco Fruit is contained in a subsequent section of this report.

- The $150,000 deposit made on October 30, 1978, represents the balance received from the redemption of the certificate of deposit which was purchased on August 1, 1978. As noted previously, the certificate was cashed to repay the loan received from the First American Bank on September 29, 1978. Interest income of $4,103.43 was also included in the total deposit.

- The $150,000 deposit made on December 15, 1978, represents funds totaling $75,000 which were borrowed by Mr. Eng from the First American Bank and $75,000 which were returned to the account from proceeds of a financing made to Overseas Homes. The latter transaction was recorded in Southern Investment's records as a loan to the small business concern.

By check dated December 12, 1978, Southern Investment disbursed $75,000 to Overseas Homes. The funds were deposited into the account of Overseas Homes on December 14, 1978.

Also on December 12, 1978, Overseas Homes issued a check payable to Mr. Richard Huff. According to Dr. Hsu, the check was disbursed to Overseas Homes in connection with a business arrangement involving the purchase of a large quantity of cigarettes, worked out by Mr. Eng. Dr. Hsu stated that the $75,000 check was disbursed to Mr. Huff as a deposit on the cigarettes but the transaction was subsequently terminated and the check was returned to Southern Investment by Mr. Huff. Dr. Hsu stated that Overseas Homes was not responsible for repaying the $75,000 advanced by Southern Investment.

Mr. Huff is President of Angelia Vending Machines, Inc. (Angelia Vending). The company is a small business concern which received financing from Southern Investment.

The $75,000 check contains an endorsement purported to be that of Richard Huff. Mr. Huff stated that he did not endorse the check and had no knowledge of it. As noted above, the check was deposited into Southern Investment's account on December 15, 1978.

Additional information regarding financing to Overseas Homes and Angelia Vending is contained in a subsequent section of this report.

Southern Investment's accounting functions are generally assigned to Mr. Donald Eng, who is one of Mr. George Eng's sons. Donald Eng serves as Treasurer of the corporation. Substantially all checks issued from the account of Southern Investment were co-signed by both George and Donald Eng.

Of the total funds disbursed by Southern Investment to finance small business concerns, at least $147,632 were paid to First American Bank and/or Mr. NeSmith as follows:

Small Concern	Amount
Gallery Construction Company, Inc.	$ 51,000
Pemco Fruit, Inc.	62,200
Bulloch Ventures, Inc.	34,432
TOTAL	$147,632

Additional information concerning the above financings are included in subsequent sections of this report.

In response to questions relating to these matters, Mr. Eng continued to claim that he had made a private capital investment of $500,000 into the licensee. However, Mr. Eng offered no specific information or documentation to support this contention and his answers to questions relating to the claimed investment were generally vague and uninformative.

Possible Conspiracy to Defraud SBA - Title 18 U.S.C. Section 371

Possible Misapplication of Funds Loaned to Restaurant Specialists, Inc. - Title 18 U.S.C. Section 657

Conflict of Interest on Financing to Restaurant Specialists, Inc. - Section 107.1004(a) and Section 107.1004(b)(5) of SBA Rules and Regulations (Revision 5)

Mr. George Eng may have conspired with Mr. David Young and others to use Restaurant Specialists as a conduit for obtaining licensee funds for personal and other unauthorized uses. Of the total funds disbursed, $105,850 appears to have been received by Mr. Eng personally, $18,000 was deposited into the account of Eng Enterprises, $2,075 was returned to Southern Investment, and $10,000 was disbursed to Mr. Eng's sister. The investigation disclosed no indication that the small business concern is actively engaged in business activities and, as such, appears to be a passive corporation which was used solely as a conduit for diverting funds from the licensee for the unauthorized purposes. In this regard, various loan documents were falsified and an endorsement on a $2,075 check was apparently forged.

Restaurant Specialists Associates, Inc. (Restaurant Specialists) was incorporated under the laws of the State of Georgia on September 1, 1978, by Mr. David Young. The corporation was established to franchise restaurants under the name "Trader Eng's Hibachi Steak House".

On November 6, 1978, Southern Investment made a $150,000 financing to Restaurant Specialists.

The total financing consisted of a $90,000 loan and a $60,000 purchase of common stock in the small concern. The stated purpose of the financing was to provide the small concern with start-up and working capital.

Two checks in the amounts of $90,000 and $60,000 were issued to Restaurant Specialists by Southern Investment on November 7. The funds were deposited into an account in the name of the small concern on November 9, 1978. The account was opened on the same date with an initial $100 deposit. No additional deposits were made to the account through January 1979. During the period November 1978 through January 1979, funds totaling $146,732 were disbursed from the account as follows:

Amount	Date Paid	Payee
$100,000.00	November 10, 1978	Eng Enterprises, Inc.
5,000.00	November 12, 1978	Eng Enterprises, Inc.
10,000.00	November 3, 1978	Shirley Lam
6,000.00	November 14, 1978	David Young
10,000.00	November 13, 1978	Sutherland Eggs, Inc.
2,000.00	November 24, 1978	Mon Fong Wo Company
2,075.00	November 20, 1978	W. Williams
500.00	December 1, 1978	David Young
5,850.00	December 8, 1978	Ken Chack
18.88	December 26, 1978	Bank Charge
1,600.00	December 10, 1978	Mike Chen
1,688.50	December 18, 1978	Lawson & Davis, Attornies
2,000.00	December 29, 1978	Mike Chen
$146,732.38	TOTAL	

All checks were signed by David Young.

The investigation disclosed that proceeds totaling at least $136,525 from the financing were used to benefit Mr. George Eng, Mr. Eng's sister, and corporations owned or controlled by Mr. Eng as follows:

- The $100,000 disbursement made to Eng Enterprises, Inc. (Eng Enterprises) on November 10, 1978,represented payment for the exclusive right to operate or franchise restaurants under the trade name of "Trader Eng's Hibachi Steak House". An agreement between Eng Enterprises and Restaurant Specialists was entered into to this effect on November 11, 1978. As noted previously, Eng Enterprises operates two Chinese restaurants in the Atlanta area under the trade name.

  Mr. Young explained that it was not his intent to open and operate restaurants himself. Instead, he stated that he planned to sell rights to use the trade name "Trader Eng's Hibachi Steak House" to other prospective restaurant operators on an area wide basis excluding the State of Georgia where Mr. Eng was already operating under the name. According to Mr. Young, a purchaser of a franchise would be entitled to sell additional franchises in his exclusive area as desired. Mr. Young described the planned operation as being a pyramid sales plan in that the proceeds from subsequent sales of franchises would be returned to Restaurant Specialists.

The $100,000 disbursement to Eng Enterprises was deposited into the corporation's operating account on November 10, 1978. By check dated November 11, 1978, the $100,000 was transferred out of the account to George Eng. The check indicates that the disbursement represented a personal loan to Mr. Eng.

Initially, Mr. Eng implied that the $100,000 was deposited into his personal account with the First American Bank. Subsequently, when a request was made of Mr. Eng to furnish personal bank records showing the disposition and use of the funds, he stated that the funds were not deposited into his personal account and that he was not sure where they were deposited. The check was negotiated on November 11, 1978, at the First American Bank where Mr. Eng maintains a personal checking account. Although Southern Investment also has an account at the bank, the proceeds from the check were not deposited into the licensee's account.

- The $5,000 disbursement made to Eng Enterprises by check dated November 12, 1978, was noted "for supply". The check was deposited to Eng Enterprises' account on November 13, 1978, and used to pay general operating expenses. According to Mr. Eng the receipt of the funds represented payment for Hibachi Tables which were sold to the small concern.

- The $10,000 check issued to Shirley Lam on November 13, 1978, is also noted "for supply". The proceeds of the check were deposited to the personal account of Shirley Lam in the Virginia National Bank, Norfolk, Virginia.

  Mrs. Lam is Mr. Eng's sister. She stated that she had never heard of Restaurant Specialists and explained that the $10,000 was received as payment for restaurant decorations and fixtures which were sold by George Eng on her behalf. Mrs. Lam stated that there was no bill of sale or other written documents prepared in connection with the sale and she does not know who received the decorations and fixtures or in which restaurants the items were installed.

- The $10,000 disbursement made to Sutherland Eggs, Inc. (Sutherland Eggs) on November 13, 1978, represented a payment made on an account owed to the firm by Eng Enterprises, d/b/a Trader Eng's. Sutherland Eggs is a wholesaler of eggs, poultry, and vegetables and has supplied food products to Mr. Eng's restaurants for many years.

- The $2,000 disbursement made to Mon Fong Wo Company by check dated November 24, 1978, was applied against an account owed to the firm by Eng Enterprises, d/b/a Trader Eng's. According to the proprietor of Mon Fong Wo Company, the firm was engaged in importing food products for resale in the United States.

The proprietor stated that Mr. Eng was a long time customer and friend.

- The $2,075 disbursed to W. Williams by check dated November 20, 1978, was deposited into the account of Southern Investment with the First American Bank in Warm Springs, Georgia. The check shows that its purpose was to repay a $2,000 loan plus interest of $75.

  Southern Investment's records show that the funds were received as a payment on the loan made to New WAVE. As noted previously, Mr. Wilhelm Williams is a principal of the small concern.

  Although the check contains an endorsement of W. Williams, Mr. Williams advised that the signature on the check was not his and that he had no knowledge of the check. Mr. Williams also stated that he had never heard of David Young or Restaurant Specialists.

- The $5,850 disbursement to Ken Chack by check dated December 8, 1978, was deposited without endorsement to the account of George Eng in the First American Bank in Warm Springs, Georgia.

- The $1,600 disbursed to Mike Chen by check dated December 10, 1978, was deposited to the operating account of Eng Enterprises with the First National Bank of Atlanta. The check indicates that its purpose was to repay travel expenses.

The investigation disclosed nothing to indicate that Restaurant Specialists was actively engaged in business activities. As noted previously, the only deposits made to the firm's checking account during the period November 1978 through January 1979 were an initial $100 deposit and the proceeds from the Southern Investment financing. The firm's address of record is occupied by Great Far East Trading Company, Inc. which was incorporated by Theodore Chao. Mr. Chao is an attorney who has represented Mr. Eng in various matters. The firm's accounting records consist only of bank statements which were in the custody of Mr. Eng.

The financing to Restaurant Specialists was identified and reported to SBA in a report of examination prepared on the licensee's operations for the period ending December 31, 1978. The matter was referred to the SBA General Counsel's office who issued an opinion stating that the financing constituted a conflict of interest.

On May 1, 1979, Mr. William Lawson, Attorney for Southern Investment, and Messrs. George and Donald Eng met with Mr. Arthur Cyr, Director of SBA's Investment Division. As evidenced by a letter dated May 1, 1979, from Mr. Lawson to Mr. Cyr, an agreement was proposed to correct the conflict of interest question raised by SBA. In the May 1, 1979, letter, Mr. Lawson states:

> "Since, as we discussed, you feel that the payment from RSA to Eng Enterprises may fall under the conflict of interest provisions of the Regulations, and because, as Mr. Eng indicated in the meeting, he desires to avoid even the appearance of conflict, Mr. Eng and Southern, while not admitting the existence of any violation of the Regulations, proposes the following action to resolve any

> questions and even the appearance of conflict: (a) Eng Enterprises will repay to RSA the franchise fee of $100,000 and RSA will repay the same to Southern; (b) Eng Enterprises will provide the services and goods, as contracted with RSA, and will abide by the provisions of its agreement with RSA without charging any franchise fee; and (c) RSA will retain only the $50,000 working capital financing needed in its operations and Southern will retain its 40% interest in RSA. Hereafter, and not without SBA's prior written approval, Southern will not finance franchise operations, other than in the ordinary course where no associate of Southern is involved.
>
> I trust this proposed action by Mr. Eng and Southern will meet with SBA's approval and eliminates any questions concerning the transaction entered into in good faith by our client. As indicated in our meeting, there are many worthy disadvantaged businessmen in Atlanta and the surrounding area in need of the assistance rendered by Southern under the 301(d) program, and speedy resolution of this issue will permit it to continue to provide such assistance. For this reason I hope that the above outlined proposal meets with SBA's approval and that Southern's requested funding will be expedited."

No subsequent action was taken with regards to this matter by SBA pending results of the investigation.

Possible Conspiracy to Defraud SBA - Title 18 U.S.C. Section 371

Possible False Statements - Title 18 U.S.C. Section 1006

Possible Misapplication of Funds Loaned to Atlantic Capital Corporation - Title 18 U.S.C. Section 657

Conflict of Interest on Financing to Atlantic Capital Corporation - Section 107.1004(a) and 107.1004(b)(5) of SBA Rules and Regulations (Revision 5)

Mr. George Eng may have conspired with Mr. Richard Tanaka and others to divert funds from the licensee for unauthorized purposes. In this regard, entries were made in the licensee's books and records and various loan documents were prepared indicating that a legitimate financing had been made to Atlantic Capital Corporation (Atlantic Capital). Proceeds from the financing to Atlantic Capital were used for the benefit of corporations owned and/or controlled by Mr. Eng. Other possible conspirators include Messrs. Donald and Kenneth Eng. Donald Eng handles the licensee's account functions. Kenneth Eng signed checks on the account of a corporation owned by Mr. Eng which were used for unauthorized purposes. Both Donald and Kenneth Eng are sons of George Eng.

In August 1978, Southern Investment provided financing to Atlantic Capital in the amount of $70,000. The financing is evidenced by two subordinated notes for $50,000 and $20,000 dated August 8, and August 25, 1978, respectively. The notes provide for the entire principal of the loan to become due and payable on September 30, 1986. Other documents show that the purpose of the financing was to provide working and start-up capital for the small concern.

Atlantic Capital was incorporated in the State of Georgia on December 5, 1977, by Richard Tanaka. The corporation was formed to operate as a commercial finance and leasing concern. Documentation contained in the licensee's files indicate that the corporation was operated out of Mr. Tanaka's residence.

By checks dated August 8 and August 25, 1978, Southern Investment disbursed the $70,000 loan proceeds to Atlantic Capital in two increments of $50,000 and $20,000 each. The funds were deposited on Atlantic Capital's account on August 8 and 28 respectively.

At the time the initial deposit was made, the Atlantic Capital account had a balance of 71 cents. The account was relatively inactive for the period August through October 1978 during which time five transactions were paid from the account as follows:

Amount	Date	Payee
$40,000.00	August 9, 1978	Tara Memorial Gardens, Inc.
15,000.00	August 25, 1978	Tara Memorial Gardens, Inc.
300.00	August 31, 1978	Theodore T. H. Chao, Esq.
7,000.00	September 25, 1978	Tara Memorial Gardens, Inc.
3,231.00	October 18, 1978	Tara Memorial Gardens, Inc.
$65,531.00	TOTAL	

The investigation disclosed the following regarding the above disbursements:

- The $40,000 and $15,000 disbursements made on August 9 and 25, 1978, were deposited into an account in the name of Tara Memorial Gardens with the First State Bank of Stockbridge, Georgia. According to Mr. Eng the funds were paid to Tara Memorial Gardens for "acquisition of negotiable contract obligations". The funds were disbursed from the account during the month of August 1978. An analysis of disbursements made from the account during the period August 10 through August 31, 1978, show that checks totaling $61,160 were paid from the account for the following purposes:

$ 8,091	Working capital expenditures of Tara Memorial Gardens.
4,600	Transferred into another account in the name of Tara Memorial Gardens, Imprest Funds.
10,000	Invested into Merchandise Fund Certificate.
2,369	Loan payments made to First American Bank ($2,101) and First National Bank of Atlanta ($268).
1,000	Advanced to Atlanta Consulting Associates. According to Mr. Eng this fee was paid for consulting services rendered. Atlantic Consultants is managed by Kenneth Eng who also serves as Manager to Tara Memorial Gardens.
5,100	Loan Repayment made to George Eng.
30,000	Advanced to and deposited into the operating account of Eng Enterprises with First National Bank of Atlanta. According to Mr. Eng the funds were disbursed to Eng Enterprises to repay loans and/or advances made to Tara Memorial Gardens.
$61,160	TOTAL

The $7,000 disbursement made from the account of Atlantic Capital on September 25, 1978, was posted to Tara Memorial Garden's account on the following day. By check dated September 25, 1978, the funds were disbursed from the account and deposited to the operating account of Eng Enterprises with the First National Bank of Atlanta. A notation on the check indicates that the purpose of the disbursement was for "loan repayment".

The $3,231 disbursement made from the account of Atlantic Capital on October 18 was deposited into Tara Memorial Garden's account on October 20, 1978. An analysis of the disbursements made by Tara Memorial Gardens during the period October 18 through 31, 1978, disclosed that $975 of the funds were disbursed back to Atlantic Capital Corporation and deposited on October 18, 1978, $1,000 was disbursed to Atlantic Consulting Associates, and the balance was used for general operating purposes of Tara Memorial Gardens.

The $300 disbursement to Theodore Chao on August 25, 1978, represents a legal fee paid in connection with the loan.

As noted previously, Mr. George Eng is the principal owner of both Tara Memorial Gardens and Eng Enterprises. Atlantic Consulting Associates is owned by Kenneth Eng.

All checks paid from the accounts of Tara Memorial Gardens and Atlantic Capital were signed by Kenneth Eng and Richard Tanaka respectively. Donald Eng is responsible for the accounting functions of both the licensee and Eng Enterprises.

Possible Conspiracy to Defraud SBA - Title 18 U.S.C. Section 371

Possible False Statements - Title 18 U.S.C. Section 1006

Possible Misapplication of Funds Loaned to Lights & Locks - Title 18 U.S.C. Section 657

Mr. George Eng may have conspired with various other individuals to divert funds from the licensee for unauthorized purposes and to falsify records of the licensee in order to conceal the misuse of funds. In this regard, various loan documents were prepared and entries made in the licensee's books and records to indicate that a legitimate financing had been made to Mr. and Mrs. Donald Macleod d/b/a Lights & Locks. Proceeds from the loan were used to benefit individuals with whom Mr. Eng was associated. Entries were also made in the licensee's books and records showing that the loan was repaid by principals of Lights & Locks when, in fact, licensee funds were diverted through another small business concern and used for this purpose.

On December 30, 1977, Southern Investment provided financing to Donald L. and Helen Marie Macleod d/b/a Lights & Locks in the amount of $50,000. A $1,250 loan discount was deducted from the proceeds of the loan and a $48,750 money order dated December 30 was issued to Mr. and Mrs. Macleod from the licensee's account with the First American Bank.

The loan to Lights & Locks is evidenced by a 90 day consumer note dated December 30, 1977. On March 31, 1978, a 60 day extension was authorized by Southern Investment and a second consumer note effected which extended the payment due date to May 30, 1978. Other documentation contained in the licensee files indicates a corporation was being formed in the name of Lights & Locks, Inc., and that the loan was made for the purpose of providing working and start-up capital to the small concern.

Lights & Locks' address of record is 3775 Kirby Drive, Houston, Texas. An employee of the Office of the Secretary of the State of Texas advised that a corporate charter was never filed for the small concern. The investigation disclosed that the business never became active.

On January 4, 1978, the $48,750 money order was cashed at the Westbury National Bank in Houston, Texas. Proceeds of the money order were used as follows:

$ 2,500	Deposited to Mr. Macleod's personal checking account with the Westbury National Bank on January 4, 1978. This amount was transferred to a savings account with the Gibraltar Savings Association on the same date.
8,000	Purchase cashier's check number 106026. The cashier's check was made payable to the order of Arthur R. Ammons, Trustee.
8,625	Purchase cashier's check number 106027. The cashier's check was made payable to the order of Arthur R. Ammons, Trustee.
10,000	Purchase cashier's check number 106028. The cashier's check was made payable to U.M.C.
10,000	Purchase cashier's check 106029. The cashier's check was made payable to U.M.C.
9,605	Purchase cashier's check 106030. The cashier's check was made payable to U.M.C.
$48,750	TOTAL

The two cashier's checks totaling $16,625 which were issued payable to Arthur Ammons, Trustee, were transacted at the Merchant's Park Bank in Houston, Texas on January 4, 1978. Funds totaling $7,500 were used to purchase a certificate of deposit in the name of Arthur R. Ammons, Trustee, and $1,125 were used to purchase another cashier's check in the name of Arthur R. Ammons, Trustee. Officials of the Merchant's Park Bank could not identify, from available bank records, the disposition of the addition $8,000 proceeds from the cashier's checks.

On January 9, 1978, the $7,500 certificate of deposit was cashed by Mr. Ammons and proceeds were used to purchase two additional $3,750 cashier's checks from the Merchant's Park Bank. Proceeds from these checks along with the $1,125 check purchased on January 4, 1978, were deposited into account number 124-891 with the Security National Bank of Houston, Texas. An official of the Security National Bank explained that account 124-891 was an individual account in the name of Mr. and Mrs. Arthur Ammons.

The three cashier's checks totaling $29,625 which were issued by the Westbury National Bank payable to U.M.C. were deposited into an account with the Chemical Bank & Trust Company in Houston, Texas on January 5, 1978. The account was opened on the same date in the name of the Universal Muslim Community by a lady known only as Her Royal Highness The Princess Jeanne of Hohenzollern.

The account remained opened for eight days during which time five disbursements were paid from the account as follows:

Amount	Description of Transaction
$ 1,414	Paid to Chemical Bank of Houston, Texas. No other information regarding this disbursement was disclosed by the investigation.
15,000	Wire transfer to the Chemical Bank of New York for deposit to account number 2-00-975.
268	Paid to Continental Airlines. This disbursement appears to represent a purchase of an airline ticket.
7,943	Wire transfer to the Chemical Bank of New York for deposit to account number 2-00-975.
5,000	Cashier's check purchased and disbursed to the Del Rio Bank & Trust Company for credit to the account of the Fashion Circle. Although the Del Rio, Texas phone book disclosed that no active business is operating under the name of The Fashion Circle in the Del Rio area, the disbursement appears to represent payment of a personal account.
$29,625	TOTAL

Regarding the $22,943 wire transfers made to the Chemical Bank of New York, an official of the bank advised that account 2-00-975 into which the funds were deposited, is an individual account in the name of Her Highness The Princess Jeanne.

Mr. Donald Macleod acknowledged that he applied for the loan made by Southern Investment to Lights & Locks but denied receiving any of the loan proceeds. Mr. Macleod provided information regarding the loan as follows:

- He had, in the past, been actively involved in the lighting business and had done some research and planning to determine the feasibility of starting a lighting fixture business in Houston and other areas of Texas.

- He was contacted by Dr. Bill Marquart and asked to prepare a financial package on the proposed business. An agreement was entered into between Dr. Marquart and himself which provided that he would be an equal partner in the business with Dr. Marquart's sister, Ann Marquart, in exchange for the Marquart's arranging financing of $1,000,000 for the business venture. It was planned that the financing would be obtained through the World Conference of Muslims, in Paris, France.

- The financing was to be obtained from the Muslims by George Eng with the assistance of Ann Marquart and her cousin, Her Royal Highness The Princess Jeanne, who was represented to be a United Nations Representative for the Islamic people. He was told that Ann Marquart was also an ambassador-at-large for the Islamic people.

- The $50,000 loan from Southern Investment was obtained to provide start-up costs until the permanent financing could be arranged. It was agreed that Mr. Eng would repay the loan to Southern Investment with proceeds of the $1,000,000 loan he obtained from the Universal Muslim Community.

- He endorsed the money order issued to him by Southern Investment. He received $2,500 from the proceeds of the money order to repay him for advances which he had made to Ann Marquart. The remainder of the money was split between Ms. Marquart and Her Royal Highness The Princess Jeanne. Ms. Marquart's attorney, Arthur R. Ammons, handled a portion of the money as trustee.
- So far as he knows, the permanent funding was never obtained from the Universal Muslim Community.
- He subsequently became concerned about the note which he had signed to Southern Investment. To satisfy his concerns, Ms. Marquart wrote to Mr. Eng on August 8, 1978, stating that she and Princess Jeanne would be responsible for repayment of the note to Lights & Locks.

Ms. Marquart confirmed much of the information provided by Mr. Macleod. She stated that the $50,000 proceeds from the Southern Investment loan were used to pay loan points to the Universal Muslim Community. According to Ms. Marquart, Mr. Eng had initially agreed to obtain the $1,000,000 loan from the Universal Muslim Community but subsequently advised her that he could not go through with the loan because of limitations imposed on him by SBA regulations.

With regard to the loan proceeds which were disbursed to and handled by Arthur R. Ammons as Trustee, Mr. Ammons advised that:

- He has acted as trustee for Ann Marquart on several occasions but has no recollection of receiving the $16,625 in January 1978.
- He has no records showing how most of the funds were disbursed by him.

Records were located by Mr. Ammons showing that disbursement totaling $1,625 were made by him on behalf of Ann Marquart from the proceeds of the cashier's checks as follows:

Amount	Payee and/or Purpose
$ 500	Check issued payable to cash and given to Ann Marquart.
500	Payment made to Arthur Ammons as payment on account for legal services rendered.
500	Payment made to Mr. Jim Termaine to reimburse a loan fee paid to Ms. Marquart.
125	Disbursed to Gary Pardue. Mr. Pardue is Ms. Marquart's husband.
$1,625	TOTAL

On May 26 and November 11, 1977, multicount indictments were filed in the United States District Court, Southern District of Texas against Flarestine Antonette Pardue (also known as Flarestine Antonette Marquart and Ann Marquart), William C. J. Marquart, III, (also known as Dr. W. C. J. Marquart, III and Bill Marquart) and Gary Stewart Pardue. The indictments alledge that the three individuals conspired to devise a scheme to defraud clients and, in so doing, committed various violations of Title 18 U.S.C. dealing with mail fraud and transportation of funds in interstate commerce. A Harris County Grand Jury also charged Ms. Marquart with three counts of felony theft and three counts of misapplication of funds.

The U. S. District Court case against the three defendants is currently pending trial in Houston, Texas.

On December 11, 1978, a $50,000 deposit was made to the account of Southern Investment. The deposit was recorded in the licensee's books and records as a repayment of the loan made to Lights & Locks.

Records of the First American Bank show that the source of the $50,000 deposited on December 11, 1978,was as follows:

$20,000	Cashier's check remitted by Mr. Richard Huff, Jr. to the order of Richard Huff, Jr.
26,000	Cashier's check remitted by Angelia Vending, Inc. to Richard Huff, Jr.
4,000	Personal check issued on the account of George Eng.
$50,000	TOTAL

Mr. Richard Huff is President of Angelia Vending Machines, Inc. (Angelia Vending) which also received financing from Southern Investment. Mr. Huff explained the following regarding the transaction:

- Southern Investment had committed to loan Angelia Vending $150,000 of which approximately $30,000 was disbursed during the period September through November 8, 1978.

- By check dated November 16, 1978, Southern Investment made a $50,000 disbursement against its commitment to the small concern.

The funds were deposited to a checking account in the name of Angelia Vending on November 17, 1978, and subsequently transferred into a savings account in Mr. Huff's name.

- Approximately one week after the funds were disbursed to Angelia Vending, Mr. Eng requested that the money be returned to Southern Investment and promised to provide the small concern with the entire $120,000 remaining undisbursed on the commitment.
- He returned to Mr. Eng $46,000 of the loan proceeds by withdrawing the amount from the savings account and purchasing two cashier's checks in amounts of $20,000 and $26,000. The additional $4,000 was retained by Mr. Huff.
- He has no knowledge as to what Mr. Eng did with the two cashier's checks. He has never heard of Lights & Locks and has no knowledge as to why its loan was repaid with proceeds advanced to Angelia Vending.

Both Mr. and Mrs. Macleod stated that they were unaware that the loan to Lights & Locks had been repaid to Southern Investment and neither claimed to have any knowledge as to who or how loan was repaid. Ms. Marquart also stated that she had no knowledge of the loan repayment.

Mr. Eng initially acknowledged that he repaid the loan to Lights & Locks himself. According to Mr. Eng, this was done because he realized that the loan was made under false pretenses and he did not want SBA to know that he had made a fraudulent loan. Subsequently, Mr. Eng stated that:

> "Based upon various communications from Donald McLeod and Ann Marquart, advice of counsel for Donald Mcleod, and other factors, Southern Investment was misdirected and, through inadvertent error, reflected such loan as paid; in fact, said loan has not been paid as of this date, and is presently outstanding......
>
> Although it was originally intended that the loan was to be repaid by principals of Southern Investment, such action was not taken following full examination of all facts and circumstances relating to the loan transaction."

Mr. Eng also stated that he had business dealings with Her Royal Highness The Princess Jeanne who accompanied him to Paris, France where he was introduced to the President of the Universal Muslim Community. Regarding this matter, Mr. Eng stated:

> "Princess Jeanne has been represented to be an ambassador of Universal Muslim Community; in this capacity, she accompanied George Eng of Southern Investment to Paris, France, for discussions with Mr. A. Gafoor, represented to be the President of Universal Muslim Community, and relating to possible capital financing of Southern Investment, subject to SBA approval. No agreement was consummated."

Additional information regarding Southern Investment's financing to Angelia Vending is included in a subsequent section of this report.

Possible False Statement - Title 18 U.S.C. Section 1001 and Title 15 U.S.C. Section 645(a) - Inaccurate Information Submitted to SBA Regarding Fees Paid for Preparation of License Application

Mr. George Eng made a possible false statement to SBA in the License Application regarding compensation paid to Interamerican Marketing Association (Interamerican Marketing) for assistance provided to him in the formation of Southern Investment and processing the license application. Although documentation was provided to SBA showing that no fees were paid to Interamerican, the investigation disclosed that funds totaling $20,000 were disbursed to the firm shortly after the initial funding was received from SBA. In addition, Interamerican Marketing and/or its principals received proceeds totaling $113,637 from a financing made by Southern Investment to Greater Americas Corporation, Inc. (Greater Americas).

Interamerican Marketing was incorporated on May 14, 1976, in the State of Delaware as a non-profit trade association. The latest annual report filed for the corporation shows that its directors consisted of Messrs. H. Ray Baker and Antonio A. Sobral, Jr. The report also shows the corporation's address as:

Suite 736
2341 Jefferson Davis Highway
Arlington, Virginia

The licensee application submitted to SBA on July 5, 1977 shows that Interamerican Marketing was Southern Investment's representative in the Washington, D. C. area. The application states:

> "J.B. Baker assisted Southern Investment and Funding Corporation, Inc., in the formation of the corporation and process of the license application. No compensation was paid in that the services were provided to Mr. Eng from his affiliation with the Interamerican Marketing Association, a non-profit corporation, as as Associate Corporate Member. Incorporation and filing fees were paid by Southern Investment and Funding Corporation Inc."

On November 17, 1977, an unnumbered check was paid from the account of Southern Investment to the order of George Eng. The check indicates that it was issued to purchase a cashier's check.

The check was transacted at the First American Bank in Luthersville, Georgia and used to purchase a bank money order payable to George Eng.

The money order was endorsed by Mr. Eng and deposited to the account of Interamerican Marketing with the First Virginia Bank in Fairfax, Virginia.

Mr. Eng stated that Interamerican Marketing helped the licensee become incorporated and assisted in preparing the license application submitted to SBA. Mr. Eng explained that the following occurred:

- Several years ago, he attended a seminar in Chicago, Illinois which was sponsored by Interamerican Marketing dealing with the formation of MESBIC's.

- He agreed to pay Interamerican Marketing $25,000 if the firm was successful in obtaining a MESBIC license for Southern Investment by May 1977.

- The license was obtained by Interamerican Marketing after the May 1977 deadline. As a result, he refused to pay the full $25,000 fee. Instead, he paid the association $5,000 from his personal account.

When Mr. Eng was asked to explain the $20,000 money order issued to Interamerican Marketing from licensee funds, he stated that he could not recall the purpose of the disbursement. Subsequently, Mr. Eng advised:

> "$25,000.00 was paid to IMA as a membership contribution by George Eng... $20,000.00 was paid to George Eng as salary/advance salary, which funds were applied by him on account of the $25,000.00 membership fee described... above."

Mr. Edwin Baker, a former official of Interamerican Marketing, and son of H. Ray Baker, advised that he believes that the $20,000 payment made to Interamerican Marketing represented a membership fee purchased by Southern Investment into the association. Mr. Baker could not be specific as to the benefits that the licensee could derive from being a member of the association.

In addition to the $20,000 paid to Interamerican Marketing from licensee funds, the association and/or its principals also received $113,637 from the financing made to Greater Americas Corporation by the licensee. Details regarding this financing are provided in the following section of this report.

Possible Conspiracy to Defraud SBA - Title 18 U.S.C. Section 371

Possible False Statements - Title 18 U.S.C. Section 1014

Mr. Edwin Baker may have conspired with Mr. Dean Benshoff and possibly others to use Greater Americas Corporation, as a conduit for obtaining licensee funds in the amount of $150,000. The funds advanced by the licensee were generally used to benefit various individuals and/or other corporations with which Messrs. Baker or Benshoff were associated. In this regard, documentation was supplied to the licensee showing that Greater Americas had incurred a $90,000 obligation to Maryland Medical Supply, Inc. (Maryland Medical) for the purchase of used medical equipment valued in excess of $111,000. The investigation disclosed that the equipment had a value substantially less than the amount represented and that aspects of the obligation incurred by Greater Americas to Maryland Medical were questionable. The investigation disclosed nothing to indicate that Greater Americas or Maryland Medical were actively engaged in business activities and, as such, appear to be passive corporations which were used to obtain funds from the licensee for use by other corporations and/or individuals.

Title 18 U.S.C. Section 1014 states, in part, that whoever knowingly makes any false statement or willfully overvalues property or security for the purpose of influencing a Small Business Investment Company may be fined, imprisoned, or both.

On November 17, 1977, the licensee approved a $150,000 financing to Greater Americas. Terms of the financing provided for the purchase of 1,000 shares of the small concern's eight percent non-cumulative preferred stock with a par value of $150 per share. The stock purchase is evidenced by a participation agreement dated November 17, 1977, and stock certificate number one issued by Greater Americas Corporation on the same date.

Although the stated purpose of the financing was for "working capital", documentation contained in the licensee files showed that a portion of the proceeds was to be used by Greater Americans to pay a $90,000 note owed to Maryland Medical for used hospital equipment which was purchased by the small concern for resale. Financial information was also provided to the licensee by Greater Americas showing that its net worth amounted to $91,000 and that its assets consisted, for the most part, of inventories valued at $179,200.

Greater Americas was incorporated under the laws of the State of Delaware by Mr. Joseph C. Ruffino in June 1976. The corporation did not become active and its incorporator transferred ownership of the corporation to Mr. Dean Benshoff. Documentation contained in the licensee files show that the corporation's address of record was 1441 U.S. 19 South, Clearwater, Florida. However, records of the Florida Secretary of State show that the corporation was never registered in the state.

Proceeds from the licensee's financing to Greater Americas were disbursed by check dated November 17 and deposited into an account with the Ellis National Bank of Clearwater in the name of Greater Americas Corporation on November 23, 1977. The $150,000 disbursed by the licensee represented the initial deposit to the account. The account remained open for 13 days during which time no additional deposits were made and disbursements were paid from the account as follows:

Amount	Payee	Purpose
$ 90,000.00	Maryland Medical Supply, Inc.	Pay note owed for medical equipment.
14,000.00	Elinor Bianco	Advances - Records indicate that advances were made to Latin American Development Associates, Inc. However, funds appear to have been deposited to a personal checking account.
8,438.29	Latin American Development Associates, Inc.	Reimbursement of salary and travel expenses.
1,500.00	Ellis National Bank	Purchase Cashier's Check 7477 to Atlantic Consultants.

5,000.00	Gertrude Benshoff	Advance-Records indicate advance made to Latin American Development Associates, Inc. However, funds appear to have been deposited to a personal checking account.
706.15	Edwin Baker	Travel Expenses.
200.00	Dean Benshoff	Travel Expenses.
1,074.00	Elinor Bianco	Travel Expenses
16.00	Ellis National Bank	Various Bank Charges.
29,065.56	Community Bank	To Close Account.
$150,000.00	TOTAL	

The $29,065.56 transferred to the Community Bank was deposited into a new account with the bank in the name of greater Americas Corporation on December 8, 1978. Substantially all of the funds were disbursed during the period December 13, 1977 through January 11, 1978. Disbursements from the account included $12,023 disbursed to Elinor Bianco and $3,932.66 disbursed to Edith Baker. Although the balance of the disbursements were made for working capital expenditures, it appears that the costs were incurred by Latin American Development Association, Inc.

Regarding the above disbursements, the following is noted:

- Elinor Bianco is Mr. Dean Benshoff's daughter.
- Gertrude Benshoff is Mr. Dean Benshoff's wife.
- Edith Baker is Edwin Baker's mother.
- Atlantic Consultants is a firm owned by Kenneth Eng who is Mr. George Eng's son. According to Mr. Benshoff, the payment represented a finder's fee incurred in connection with the

loan from Southern Investment.

The $90,000 disbursement to Maryland Medical was made by wire transfer on November 28, 1977. The transfer was authorized by Edwin Baker on behalf of Greater Americas. The funds were deposited into an account in the name of Maryland Medical Supply with the Bank of Virginia in Arlington, Virginia on the same date. The account was opened on November 18, 1977, with an initial deposit of $50. During November 1977, three checks were paid from the account as follows:

Amount	Date	Payee
$40,000.00	November 28, 1977	Bank of Virginia
46,809.68	November 28, 1977	Bank of Virginia
1,547.02	November 28, 1977	Edwin Baker
$88,356.70	TOTAL FUNDS AVAILABLE	

The $40,000 check issued to the Bank of Virginia was used to cover a wire transfer made to the account of Latin American Development Association (Latin American) in the Ellis National Bank of Clearwater, Florida. The funds were deposited to Latin American's account on November 29, 1977, and used, in part, to purchase a $25,000 check payable to Gene Tart. Mr. Tart provided the following information regarding the transaction:

- He was exploring the possibility of obtaining a MESBIC license from SBA. A friend of his in the Washington, D. C. area referred Interamerican Marketing to him as a potential representative for his dealings with SBA.

- In his dealings with Interamerican Marketing, he became involved in a deal whereby he agreed to loan the association $25,000 to purchase some new surplus medical equipment for resale to an individual in Florida.

- The $25,000 loan was made to Interamerican Marketing and he received a lien on the equipment purchased. He was provided documents showing that the equipment was stored in a warehouse in Maryland.

- After the loan was made, he became concerned about the collateral on the loan. He contacted the owner of the warehouse where the equipment was suppose to have been stored and learned that the equipment was not stored at the warehouse.

- He was initiating legal action against Interamerican Marketing and its principals when he was contacted by Dean Benshoff. Mr. Benshoff agreed to repay the $25,000 loan and hand carried a check in that amount to the airport in Fayetteville, North Carolina where he received the check from Mr. Benshoff.

Documentation obtained during the investigation shows that Interamerican Marketing officials submitted an application for a MESBIC license to SBA on behalf of Mr. Tart. The name of the proposed licensee was Wiltar Investment Corporation, Inc.

The $46,809.68 disbursement from the Maryland Medical account to the Bank of Virginia on November 28, 1977, was used to purchase six cashier's checks from the bank as follows:

Amount	Payee
$ 9,809.68	Edwin Baker
5,000.00	Edwin Baker
1,800.00	Edwin Baker
25,000.00	Interamerican Marketing Association, Inc.
2,000.00	American Express-for account of H. Ray Baker
3,000.00	Edith Baker
200.00	Undetermined
$46,809.68	TOTAL

Regarding these disbursement Mr. Baker stated that a portion of the funds paid to him represented reimbursement of travel expenditures but that he could not be specific to the amount received for this purpose. According to Mr. Baker, the $25,000 check issued to Interamerican Marketing represented a fee for membership into the association which was purchased by Maryland Medical. Mr. Baker stated that he could not recall the purpose of the other disbursements.

Based on the above, the $150,000 proceeds of the financing to Greater Americas was received by the following individuals and/or corporations:

	Amount
Latin American Development Associates, Inc.	$ 36,548.19
Elinor Bianco	26,023.00
Gertrude Benshoff	5,000.00
Atlantic Consultants	1,500.00
Edith Baker	6,932.66
Edwin Baker	18,156.70
American Express (for account of H. Ray Baker)	2,000.00
Gene Tart (for loan repayment owed by Interamerican Marketing)	25,000.00
Interamerican Marketing Associates, Inc.	25,000.00
Greater Americas Corporation	1,996.15
Undetermined	1,843.30
TOTAL	$150,000.00

Of these disbursements, $113,637.55 were used to benefit Interamerican Marketing and/or its officials as follows:

Latin American Development Associates, Inc.	$ 36,548.19
Edith Baker	6,932.66
Edwin Baker	18,156.70
American Express	2,000.00
Gene Tart	25,000.00
Interamerican Marketing	25,000.00
TOTAL	$113,637.55

In addition to their association with Greater Americas, Messrs. Baker and Benshoff were also affiliated as principals of Latin American Development Associates, Inc., which was incorporated in March 1976 in the State of Delaware. An annual report filed with the State of Delaware on June 3, 1977, shows that the corporation's President was Edwin W. Baker and that its directors were Mr. Baker and Dean Benshoff. According to the annual report, the firm's place of business was 2341 Jefferson Davis Highway in Arlington, Virginia.

Interamerican Marketing was incorporated in the State of Delaware in May 1976 under the name of Latin American Marketing Association International, Inc. In July 1976, its name was changed to Interamerican Marketing Association, Inc. At the time that the certificate of amendment was filed in July 1976, the directors of the corporation included:

H. Ray Baker
Fernando Valez
Antonio A. Sobral, Jr.
Edwin Baker

Maryland Medical Supply, Inc. was incorporated by Mr. Edwin Baker in the State of Maryland in June 1977.

Both Mr. Baker and Mr. Benshoff stated that the $90,000 disbursement to Interamerican Marketing represented payment of a note incurred in connection with the sale of used medical equipment. Mr. Baker provided the following information regarding the transaction:

- Maryland Medical Supply was established by himself and Mr. Saul Fheldon. Mr. Fheldon is a "junk dealer" in Baltimore, Maryland and had contacts which enabled him to purchase excess medical equipment from hospitals and clinics in the Baltimore area.

- Mr. Fheldon procured used medical equipment valued at $111,665 and gave it to Maryland Medical as a capital contribution. They planned to resell the equipment to South American countries.

- They were unable to find a buyer for the equipment in South America and, instead, agreed to sell it to Greater Americas for $90,000. The sale was consumated on October 3, 1977, and a note accepted from Greater Americas Corporation as payment for the equipment.

- The $90,000 received by Maryland Medical from Greater Americas in November 1977 represented payment of the note.

- $40,000 of the funds received by Maryland Medical was transferred to Latin American to repay the corporation for advances made in connection with the transaction prior to the approval of the loan by Southern Investment.

Mr. Benshoff provided a somewhat different explanation.

- Officials of Interamerican Marketing interested him in investing into a business venture involving the purchase and resale of the used medical equipment.

- Officials of Interamerican Marketing arranged for the financing of the project from Southern Investment. The negotiations for the sale of the medical equipment was handled by the Interamerican Marketing officials.

- The equipment was purchased by Greater Americas Corporation and stored in a warehouse in Baltimore. He was unable to locate a buyer and the equipment was subsequently sold at auction by the proprietor of the warehouse.

The medical equipment purchased by Greater Americas from Maryland Medical Supply was stored in a warehouse in Baltimore, Maryland which was owned by Mr. Robert Hicks. Mr. Hicks advised that the space was leased to Mr. Benshoff. Mr. Hicks stated that Mr. Benshoff was unable to make lease payments and requested that he find an auctioneer to sell the equipment. According to Mr. Hicks, the equipment was obsolete and was sold at auction for $261. Mr. Hicks stated that Mr. Benshoff had expressed to him an opinion that the equipment had a value of approximately $10,000.

Edwin Baker stated that he did not know whether Mr. Eng or other officials of the licensee were aware of how the proceeds from the financing to Greater Americas were used.

As noted previously, Interamerican Marketing assisted Southern Investment in obtaining its license to operate as a 301(d) Small Business Investment Company. By letter dated June 10, 1977, Mr. Eng advised SBA as follows:

> "Pursuant to filing an application for the purpose of forming a section 301(d) SBIC or MESBIC corporation under the corporate name of Southern Investment and Funding Corporation, Inc., I am hereby conveying to J.B. Baker, power of attorney to represent my interests with respect to this license application.
>
> Please be advised that all matters pertaining to said application are to be made directly to Mr. Baker, as agent and attorney-in-fact for Southern Investment and Fundinh (sic) Corporation, Inc....."

J. B. Baker, also known as Bob Baker, is Edwin Baker's cousin.

Possible Misapplication of Funds Advanced to Angelia Vending Machines, Inc. - Title 18 U.S.C. Section 657

Possible False Statements - Title 18 U.S.C. Section 1006

Proceeds totaling $46,000 from a financing made to Angelia Vending Machine, Inc. (Angelia Vending) were used to repay a loan made by the licensee to another small business concern. The licensee's accounting records indicate that the amount was owed by Angelia Vending for a brief period of time after the funds were returned by the small business concern in December 1978. Although the loan balance was subsequently reduced on the licensee's records as a result of a $46,000 deposit made in January 1979, the investigation disclosed that the funds deposited were provided by the licensee's President, Mr. George Eng. This action was apparently the result of an attempt on the part of Mr. Eng to conceal the misuse of funds which were provided by the licensee to Lights & Locks.

Angelia Vending was incorporated by Mr. Richard Huff, Jr. under the laws of the State of Georgia in October 1976. The corporation is engaged in leasing and servicing vending machines.

Records of the licensee show that $79,000 was provided to Angelia Vending during the period September 27 through November 16, 1978, as follows:

Amount	Date	Description
$ 500.00	September 27, 1978	Purchase of 35,000 shares of no par common stock
23,500.00	September 27, 1978	Loan
5,000.00	November 8, 1978	Loan
50,000.00	November 16, 1978	Loan
$79,000.00	TOTAL	

Proceeds of the financing were disbursed to Angelia Vending as follows:

Amount	Date
$ 500	September 27, 1978
23,500	September 27, 1978
5,000	November 8, 1978
50,000	November 16, 1978
$79,000	TOTAL

A loan receivable ledger was established in the licensee's books and records on September 27, 1978. The ledger showed the following transactions:

Date	Transaction Amount	Account Balance
September 29, 1978	$23,500.00	$ 23,500.00
November 7, 1978	(337.21)	23,162.79
November 8, 1978	5,000.00	28,162.79
November 16, 1978	50,000.00	78,162.79
December 28, 1978	(2.88)	78,159.91
January 15, 1979	(45,455.36)	32,704.55

A complete verification of the use of loan proceeds to Angelia Vending was not made because corporate records were not made available for audit. However, selected documents obtained during the investigation show that proceeds totaling $61,768.16 were used as follows:

Amount	Payee	Purpose
$11,568.16	Palmetto State Distributors	Purchase amusement equipment.
4,200.00	Mary G. Huff	To reimburse Mr. Huff's wife for personal checks issued at the loan closing. Checks issued by Mrs. Huff included $1,250.00 paid to Atlanta Consulting for fee, $807.50 paid to Lawson & Davis Attorney's-at-Law for legal services performed in connection with the loan, and $1,450.79 paid to Lincoln Life Insurance Company for premium on Mr. Huff's life insurance.
46,000.00	Unknown	Purchase two cashier's checks which were returned to Mr. George Eng and deposited into the account of Southern Investment.
$61,768.16	TOTAL	

The $50,000 disbursement made to Angelia Vending on November 16, 1978, was deposited to the company's checking account and disbursed the following day to Mr. Huff. The check to Mr. Huff indicates that the disbursement represented a "loan from Angelia Vending". Mr. Huff stated that the funds were deposited into a personal savings account and retained in the account for a period of approximately one week at which time he withdrew $46,000 and purchased two cashier's checks in amounts of $20,000 and $26,000. According to Mr. Huff, the cashier's checks were returned to Mr. Eng at his request.

The two cashier's checks purchased by Mr. Huff were deposited into Southern Investment's account on December 11, 1978, along with a $4,000 personal check on the account of George Eng. The deposit was represented to be a repayment of the loan made to Lights & Locks.

In January 1979, a $45,455.36 reduction to the principal balance of the Angelia Vending loan was posted to the licensee's books reducing the amount outstanding to $32,704.55.

Also in January 1979, a $46,000 deposit was made to the account of Southern Investment. Although this deposit is not specifically identified in Southern Investment's records as being received from Angelia Vending, no other deposits in excess of $45,455.36 were made during the month. The funds which made up the $46,000 deposit were provided by Mr. Eng as follows:

$ 1,500	Cashier's check purchased by Mr. Eng to Western Union but not issued.
34,500	Proceeds from cashing Treasury Bonds which were issued to Mr. Eng's wife.
10,000	Personal check of George Eng.
$46,000	TOTAL

Possible Misapplication of Funds Advanced to Pemco Fruits, Inc. - Title 18 U.S.C. Section 657

Possible False Statements - Title 18 U.S.C. Section 1006

Use of Loan Proceeds Advanced to Pemco Fruit, Inc.

Southern Investment provided financing to Pemco Fruit in the amount of $150,000. Of the total financing, $75,000 was classified as a loan and $75,000 was represented to be a purchase of 400 shares of stock in the small concern. Proceeds from the sale of stock to Southern Investment were returned to and deposited into the account of the licensee. The receipt of the $75,000 was erroneously recorded in the licensee's books and records as a transfer of funds from certificates of deposit in an attempt to conceal that no private capital was invested into the licensee by its principals. Loan proceeds totaling $5,999 were used to repay personal indebtedness of Pemco Fruit principals. Other proceeds from the loan were used for business related purposes including $62,200 which were paid to the First American Bank for land and equipment purchased by Pemco Fruit.

Pemco Fruit, Inc. (Pemco Fruit) was incorporated in the State of Georgia on September 25, 1978, by Mr. E. C. Pemberton. The company is actively engaged in the operation of two fruit stands in Luthersville and Pine Mountain, Gerogia. Mr. Pemberton is the principal owner and serves as President of the corporation.

On October 3, 1978, Southern Investment provided financing to Pemco Fruit in the amount of $150,000. Of this amount, $75,000 is evidenced by a secured installment note and $75,000 represents the licensee's purchase of 400 shares of one dollar par value stock of the corporation as evidenced by Pemco Fruit Stock Certificate Number Two. Documentation contained in the licensee's file indicate that the purpose of the financing was to "purchase facilities, land, equipment and working capital".

Proceeds of the $150,000 financing were disbursed to Pemco Fruit on October 3, 1978. Four checks were issued from Southern Investment's account as follows:

Amount	Payee
402.50	Pemco Fruit, Inc. & Lawson & Davis Attornies
60,000.00	Pemco Fruit, Inc. & George Kennedy, Attorney for First American Bank
14,597.50	Pemco Fruit, Inc.
75,000.00	Pemco Fruit, Inc.
$150,000.00	TOTAL

The $402.50 disbursement to Pemco Fruit and Lawson & Davis represents fees for legal services provided by the law firm in connection with the loan.

The $60,000 disbursement to Pemco Fruit and George Kennedy, Attorney for the First American Bank, represented payment to the bank for real estate which was sold to Pemco Fruit. The real estate purchased from the bank consisted of two lots in Pine Mountain, Georgia where one of the fruit stands owned by Pemco Fruit was constructed. The real estate sale was consumated on October 29, 1978.

Records of the First American Bank show that the $60,000 was received on October 6, 1978. The bank credited $10,000 of the funds received against its reserve for bad debts account as a recovery of a loan which was charged-off in March 1977. The additional $50,000 was credited to an account entitled "other property" and apparently represents profit to the bank on the transaction.

The $14,597.50 check issued by the licensee was deposited to the operating account of Pemco Fruit on October 4, 1978, at which time the account balance was $500. During October 1978, substantially all of the proceeds from the disbursement were expended by Pemco Fruit. An analysis of the disbursements made from the account showed that the funds were used as follows:

Amount	Purpose
$ 1,164.87	Working Capital
1,418.25	Building Materials purchased
509.00	Legal fees paid
1,529.13	Equipment purchased
2,200.00	Paid to First American Bank and applied against a note owed to the bank by Mrs. Leeda Pike. Mr. Pemberton stated that the disbursement represented equipment purchased from the bank which had previously been acquired by the bank as a result of foreclosure action against a loan made to Mrs. Pike. According to Mr. Pemberton, the equipment was used by him as a trade-in on new equipment purchased by the small concern.
5,999.22	Paid to the Bank of Coweta and applied against various personal loans made to E. C. Pemberton, Verett Pemberton, and Steven Thompson.
1,777.03	Not determined.
$14,597.50	TOTAL

The $75,000 check issued by the licensee was deposited to the operating account of Pemco Fruit on October 23, 1978. On the same date, a $75,000 check issued payable to cash was paid from the account. The check, which was dated October 20, was signed by Mr. Pemberton and transacted at the bank without endorsement on the same date.

Proceeds from the check were deposited to Southern Investment's operating account on October 20, 1978, and shown in the licensee's records as a transfer of funds from certificates of deposit. Although the licensee did own a $300,000 certificate of deposit on the date of the transaction, the certificate was not cashed until October 30, and was not related to the $75,000 deposited on October 20, 1978. The results of the investigation indicates that this action was accomplished by licensee officials in an attempt to conceal the fact that no private capital was invested into the licensee as claimed by its principals.

Regarding the $75,000 returned to Southern Investment by Pemco Fruit, the investigation disclosed that Pemco Fruit's accountant had treated the disbursement as a suspensed item pending a determination of how the funds were used and to whom they were paid. To satisfy the accountant's inquiries, Donald Eng endorsed the stock certificate back to Pemco Fruit which was issued to Southern Investment for 400 shares of Pemco Fruit stock. The stock certificate was redeemed on June 29, 1979.

At the completion of the investigation, Southern Investment's books and records had not been posted subsequent to April 30, 1979. Accordingly, it was not determined how licensee officials intended to account for the $75,000 reduction to its assets.

Throughout the course of the investigation, Mr. Pemberton denied that any of the $150,000 proceeds from the financing received from

Southern Investment was returned to the licensee or George Eng. According to Mr. Pemberton, he used $60,000 of the funds to purchase the land from the First American Bank and $90,000 for improvements on the property.

Possible Misapplication of Funds Advanced to New W.A.V.E. (U.S.A.) Inc. - Title 18 U.S.C. Section 657

Possible False Statements - Title 18 U.S.C. Section 1006

Southern Investment provided financing to New WAVE in the amount of $150,000. Of the total financing, $145,000 was returned to the licensee but no reduction made in the loan balance as recorded in the licensee's books and records. The funds appear to have been redeposited into the licensee's account and recorded as a transfer of funds from certificates of deposit in an attempt to conceal that no private capital was invested into the licensee by its principals. The use of other loan proceeds could not be verified due to the unavailability of records.

New WAVE was incorporated in the State of New York in October 1978. The corporation was formed and operated by Mr. Wilhelm Williams and Mr. Vinod Vasudeva as a trading concern dealing in all types of products, raw materials, and commodities.

Messrs. Williams and Vasudeva are also directors of a corporation named W.E.V., Incorporated (W.E.V.), along with Mr. George Eng. The corporation was formed by Mr. Eng in May 1978 and incorporated in the State of Georgia for the purpose of importing and exporting merchandise into the United States and foreign countries.

Documentation obtained during the investigation indicates that New WAVE, W.E.V., and Southern Investment were operated in connection with each other. For example, a letter obtained from the licensee's files provides a description of products and services available through New WAVE. The letter states, in part, as follows:

> "CRUDE OIL
>
> Whatever the rquirement (sic) maybe - light, heavy or medium for crude oil the ultimate purchaser should make a written request stating a) destination b) quality and c) quantity to:
> Mr.G.Eng. 1328, Broadway, suite 1142-44
> New York, N.Y.10001 (U.S.A.)
>
> FINANCING
>
> We are also in a position to arrange financing for Governments - Countries, subject to approval of our Principals. To apply for the funding it would be nescessary (sic) for you to procure a Government Mandate stating in detail the amount of money needed, purpose of utilisation (sic) of these funds, list of gaurantors (sic) etc: This too would be addressed to Mr. G. Eng on the above address..."

The licensee's records show that New WAVE was provided financing totaling $150,000 during May and July 1978. The financing is evidenced by a $150,000 installment note dated July 28, 1978. The purpose of the loan was to provide working capital to the small business concern.

Two checks were issued to New WAVE from the licensee's account on May 25, and July 28, 1978, in amounts of $5,000 and $145,000 respectively. The $145,000 checks was not paid from the account until August 17, 1978.

Messrs. Williams and Vasudeva advised that New WAVE received only $10,000 from the licensee in lieu of $150,000 as reflected in the licensee's records. Mr. Williams stated that the following occurred relative to transactions with the licensee:

- He and Mr. Vasudeva were attempting to get a company organized and applied to Southern Investment for funding of $150,000 for start-up and working capital.

- The funding was approved by Southern Investment and a $5,000 initial advance was made to them by the licensee. He cashed the check and used the proceeds to pay start-up costs.

- Subsequently, they received a check for the additional $145,000 with instructions from George Eng not to deposit it until the company was incorporated. Mr. Eng wanted financial statements and other information which they could not provide since the company was in a formation stage.

- Mr. Eng requested that the $145,000 check be returned. As a result, it was mailed to Mr. Eng in Atlanta, Georgia.

- He, Vasudeva, and/or New WAVE have received two additional checks from Mr. Eng in amounts of $2,000 and $3,000. Both checks were cashed and the proceeds were used for business purposes.

Mr. Vasudeva also stated that the $145,000 check was returned to Mr. Eng.

Initially, Mr. Williams stated that he did not endorse the $145,000 check prior to his returning it to Mr. Eng. After examining the endorsement on the check, he stated that it was definitely his signature but that he did not recall endorsing the check and had been under the impression that it was not endorsed prior to being returned.

According to Mr. Williams, the three checks totaling $10,000 which were received from Southern Investment and/or Mr. Eng were cashed and the proceeds used for various business purposes. He stated that no records were maintained showing to whom and for what purpose cash payments were made.

A checkbook was provided for examination which indicated that an account was opened for New WAVE in December 1978. The checkbook contained no indication that any Southern Investment funds were deposited into the account.

As noted previously, the $145,000 check to New WAVE was paid from the licensee's account with the First American Bank in Luthersville on August 17, 1978. On August 15, 1978, a $150,000 deposit was made to the account. An official of the bank advised that the funds were transferred to the account from the bank's main office in Warm Springs. The bank official stated that she believes that the funds deposited may represent proceeds from a loan made to the licensee by the bank's branch in Warm Springs.

The $150,000 deposited to the licensee's account on August 15 was recorded in its books and records as a transfer of funds from certificates of deposit. Although a $300,000 certificate of deposit was purchased by the licensee in August 1978, it was not redeemed until October 30, and was not related to the $150,000 deposit.

Although the investigation failed to show how the $145,000 check was transacted by the First American Bank, it appears that the funds were either included in the $150,000 deposit made to Southern Investment's account on August 15, 1978, or were applied against a bank loan to Southern Investment which provided the source of funds deposited on August 15, 1978. In either respect, the check was processed by the bank on August 16 and paid from the licensee's account on August 17, 1978. Results of the investigation indicates that this action was accomplished by licensee officials in an attempt to conceal the fact that no private capital was invested into the licensee as claimed by its principals.

Possible Misapplication of Funds Advanced to Overseas Homes, Inc. - Title 18 U.S.C. Section 657

Possible False Statements - Title 18 U.S.C. Section 1001 and 1006 and Title 15 U.S.C. Section 645(a)

Use of Loan Proceeds Advanced to Overseas Homes, Inc.

Southern Investment provided financing to Overseas Homes in the amount of $127,500. Of the total financing, $102,500 was classified as a loan and $25,000 was represented to be a purchase of common stock in the small business concern. Of the $127,500 advanced to Overseas Homes, $100,000 was returned to and deposited into the account of the licensee. Receipt of the $100,000 was erroneously recorded in the licensee's books and records as a transfer of funds from certificates of deposit in an attempt to conceal that no private capital was invested into the licensee by its principals. In this regard, an endorsement on a $75,000 check issued from Overseas Homes' account to Mr. Richard Huff was apparently forged. Also, Dr. Leonard Hsu, President of Overseas Homes, submitted a possible false statement to SBA auditors which substantially overstated the small concern's indebtedness of the licensee. The balance of prodeeds advanced to Overseas Homes ($27,500) appears to have been used for business related purposes of the small concern.

Overseas Homes was established in the State of New York for the purpose of constructing low cost housing units in South American Countries. According to its President, Dr. Leonard Hsu, the firm is still in the preliminary stages of development.

The licensee approved financing to Overseas Homes in the amount of $127,500 as follows:

Amount	Date	Description
$ 25,000	September 6, 1978	Loan
25,000	September 6, 1978	Purchase of 80 shares of common stock
75,000	December 12, 1978	Loan
2,500	March 15, 1979	Loan
$127,500	TOTAL	

The funds were disbursed to Overseas Homes as follows:

Amount	Check Date	Date Paid
$ 25,000	August 31, 1978	October 3, 1978
25,000	September 6, 1978	September 8, 1978
75,000	December 12, 1978	December 18, 1978
2,500	March 15, 1979	March 22, 1979
$127,500	TOTAL	

The investigation disclosed that the $25,000 check issued to Overseas Homes on August 31, 1978, was not deposited into the account of the small concern. Instead, it was transacted at the First American Bank on October 3, 1978, and proceeds from the check were redeposited to the account of the licensee on the same date.

Receipt of the $25,000 on October 3, was recorded in the licensee's books and records as a reduction to the certificate of deposit balance. Although the licensee did own a $300,000 certificate of deposit on the date of the transaction, the certificate was not cashed until October 30, and was not related to the $25,000 deposit made on October 3, 1978. The results of the investigation indicates that this action was accomplished by licensee officials in an attempt to conceal the fact that no private capital was invested into the licensee as claimed by its principals.

Regarding the receipt and return of the $25,000 from the licensee, Dr. Hsu stated that:

- He endorsed the check and returned it to George Eng who cashed it and gave him $25,000 in cash.

- He converted the $25,000 cash to Taiwan currency and hand carried the funds to Taiwan and invested it into a corporation which he owns in Taiwan.

- The funds were used to promote housing projects in Taiwan.

The $75,000 check issued to the small concern on December 12, 1978, was deposited into its account on December 14, 1978. The funds were immediately transferred out of the account by check dated December 12 payable to the order of Richard Huff. The check indicates that the disbursement represented a loan to Mr. Huff.

The proceeds from the $75,000 check were deposited to the licensee's account on December 15, 1978, as part of the $150,000 deposit. Records of the First American Bank show that the source of the deposit included the $75,000 check to Mr. Huff and $75,000 proceeds from a bank loan to Mr. George Eng.

The $150,000 deposit made to the licensee's account on December 15th was recorded in its books and records as a transfer of funds from certificates of deposit. As of the date of the transaction, the licensee had no funds invested in certificates of deposit.

Mr. Huff is President of Angelia Vending Machine, which also received financing from the licensee. Mr. Huff stated that he did not endorse the $75,000 check and had no previous knowledge of its existence.

Regarding the issuance of the check, Dr. Hsu stated that:

- The funds were advanced to Mr. Richard Huff as a deposit on a large quantity of cigarettes which were being sold by Mr. Huff to a firm in England.

- The deal, which had been arranged by Mr. Eng, was never finalized and the $75,000 was returned to Mr. Eng. Neither he nor Mr. Huff have any obligation to repay the $75,000 to Southern Investment.

- Of the total financing, funds totaling $27,500 were deposited to the account of the small concern and appear to have been used for business related purposes of the small concern.

In connection with an SBA Compliance Audit Examination made of the licensee's records as of December 31, 1978, a confirmation letter was mailed to SBA's Compliance Audit Division which contained inaccurate information regarding the amount owed to the licensee by the small concern. As of the date of the examination, licensee funds totaling $125,000 had been advanced to Overseas Homes of which $100,000 was returned as discussed above. The confirmation letter, which was signed and submitted by Dr. Hsu, shows that Overseas Homes owed a $100,000 five year note to the licensee and that Southern Investment had purchased $25,000 worth of common stock in the small concern. By Dr. Hsu's own admission, the amount of the indebtedness was overstated by $75,000 since Overseas Homes has no obligation to repay the amount returned to the licensee as a result of the check issued to Mr. Huff.

Use of Proceeds Advanced to Bulloch Ventures, Inc.

Proceeds totaling $34,432 from the $45,000 financing made to Bulloch Ventures, Inc. (Bulloch Ventures) were used to refinance a loan owed by the small concern to the First American Bank of Warm Springs. Based on the results of the investigation, it appears as though the licensee's financing was made as an accommodation to the bank. Although a complete verification was not made of the balance of the proceeds from the loan, the funds were generally advanced to officers of the small business concern or used for working capital and related business costs. A $1,350 disbursement was made from the proceeds of the loan to Southern Investment and classified as a loan discount fee. The investigation disclosed that the proceeds from the disbursement were not deposited into the licensee's operating account.

The $1,350 payment made to Southern Investment represented a loan discount fee of three percent. Although the check to Southern Investment contains a stamp "Deposited to Account of Within Named Payee", and was processed by First American Bank on December 1, 1977, the licensee's records provide no indication that the funds were deposited into its operating account with the bank.

Use of Loan Proceeds Advanced to Consumer Mart International, Inc.

Proceeds from a $55,000 financing made to Consumer Mart International, Inc. (Consumer Mart International) were not used for authorized purposes or as contemplated. Licensee officials were aware of the misuse of proceeds and have initiated action to protect the licensee's interests in this regard.

Consumer Mart International was incorporated in September 1977 under the laws of the State of Georgia by Mr. M. K. Loo.

In December 1977, Southern Investment approved financing to Consumer Mart International in the amount of $55,000. The debt was evidenced by a note secured by a Guaranty of Indebtedness. The purpose of the loan was to provide funds for promotion of a membership discount club.

The $55,000 was disbursed to the small concern in two increments as follows:

Date	Amount
November 18, 1977	$30,000
December 18, 1977	$25,000
TOTAL	$55,000

The $30,000 disbursement made to the small business concern by check dated November 18 was deposited into an account in the name of Coordinated Capital Corporation on November 22, 1977. Coordinated Capital Corporation was formed by Mr. Loo in January 1976, for the purpose of engaging in the insurance business.

At the time of the $30,000 deposit to the account of Coordinated Capital, the account was overdrawn by $7,941. The overdraft occurred, for the most part, as a result of a $35,509 check which was paid from the account on November 4, 1977, to the Alexander Hamilton Life Insurance Company. A review of other selected transactions paid from the account during the period November through December 1977 indicates that major disbursements were made from the account to repay Alexander Hamilton Life Insurance Company for policy premiums which were collected by Coordinated Capital Corporation as agent for Alexander Hamilton Life Insurance Company.

Officials of Consumer Mart International did not provide records requested for verifying use of funds advanced to the small business concern. Accordingly, a verification of the use of the proceeds advanced to the small concern on December 18, 1977, was not accomplished.

According to licensee officials, they found that proceeds from the financing were used improperly and an agreement was effected on October 24, 1978, between the licensee, M. K. Loo, and Coordinated Capital Corporation. The agreement provided for a reduction of the principal and accrued interest balance to $37,051 and real estate valued at $25,000 was acquired by the licensee. As of the completion of the investigation, no additional payments or reductions had been made against the loan balance.

Use of Loan Proceeds Advanced to Gallery Construction Company, Inc.

Proceeds from an $88,818 financing made to Gallery Construction Company, Inc. (Gallery Construction) were used as authorized. Of the total funds advanced to the small business concern, $37,818 was used for working capital and $51,000 was paid to the First American Bank and/or its officials for equipment purchased and debt repayment.

Gallery Construction was incorporated in December 1977 by Mr. James R. Hamilton and Ms. Dianne Hamilton under the laws of the State of Georgia. The firm is engaged in buying, moving, restoring and reselling condemned houses.

In December 1977 and January 1978, the licensee approved financing to and advanced the small concern $35,000. In September 1978, the licensee's loan to Gallery Construction was increased to $88,818 as a result of refinancing.

Of the initial $35,000 disbursement, $31,000 was paid directly to First American Bank and $4,000 was deposited into Gallery Construction's account. According to Mr. Hamilton, the $31,000 was used to pay for equipment which it had obtained through a foreclosure. The $4,000 deposited to the Gallery Construction account was used, for the most part, to pay a deposit on property purchased in Luthersville, Georgia.

In September 1978 when the existing loan to Gallery Construction was refinanced, new funds totaling $53,818 were provided to the small concern and disbursed as follows:

Amount	Payee	Purpose
$21,192.50	Gallery Construction Company	Working capital including $5,362 expended for an automobile.
2,818.74	Southern Investment	Interest on $35,000 loan.
307.50	Lawson & Davis	Closing Cost & Fees.
20,000.00	First American Bank	Loan Payment
9,500.00	Howell Raysdale	Purchase of property and closing cost.
$53,818.74	TOTAL	

Mr. Hamilton explained that the $20,000 paid to the First American Bank from the proceeds of the loan was made to repay a debt which he owed to Mr. Jimmy NeSmith, President of the bank. According to Mr. Hamilton, the debt was incurred in connection with a purchase of stock in the First Palmetto Bank.

The **Chairman**. I was alarmed to read that for the 3-year period surveyed, July 1976 to June 1979, "An average of 42 percent of the operating SBIC's examined were cited for significant violations of the SBIC program rules and regulations." First, to what do you attribute this frequency with which SBIC's have committed significant regulatory violations in the past? Second, is this 42-percent figure the same today as it was when you issued this report in 1980?

Mr. **Randolph**. Yes, sir, it is. The most current semiannual report shows 41 percent. This is for the period from October 1980 to March 1982. I think the average is still around 42 or 43.

As I said in my statement, I believe the main reason is not enforcing the regulations, the pattern of waiving on the regulations, and not a real strong enforcement of the regulations. Again, as we said, there are some systemic causes.

I think one of the things that may improve the situation, just to give you an example, we are now clearing off on all of the examination letters. That is, after we issue a report the examination letter is sent to the licensees, asking them to correct certain things. Before that is sent, we clear it, to make sure that all the things that we had in the report are either addressed in that examination letter or addressed by a memo to the file, which states that it is an item that doesn't have to be corrected or the item has already been corrected. Those types of things I think will have an effect over the years. It is too soon to tell how much effect these changes will have. It will take a couple of years before you will see the reduction in findings, I think.

The **Chairman**. On the other hand, 42 percent, that is a big chunk of those participating in the program that are in significant violation. Do you really feel it is going to take a 2-year period to bring that figure down?

Mr. **Randolph**. Yes, until we get the new regulations out and until the effect of the stricter enforcement takes place and until these messages get out, it will be a year before we examine SBIC's again and then we will really be able to see whether these changes have any effect.

The **Chairman**. Of course, I suppose the first message that is going to get out from here is that you don't have enough people to go ahead and reduce the violations and enforce the law. That bothers me also.

Mr. **Randolph**. I think maybe they might have had that idea anyhow.

The **Chairman**. Yes. Well, I mean, the problem is that you can write all the new regulations and have a new system in place, and hopefully that might accommodate personnel-wise some of the budget cuts that have been made, but still all in all it is human beings that are going to have to oversee this operation in order to bring it in line. Wouldn't you agree with that?

Mr. **Randolph**. Yes, but I think if we had that bill passed which I suggested at the end of the statement, that we estimate there are about 25 to 30 percent of the companies which we could put on a 2-year cycle basis, and I think that would significantly help us.

The **Chairman**. Another area of concern that I have asked the agency about in the past in other hearings has been its prelicensing examination for prospective licensees. One recent case that has come to my attention involves the Finevalor Capital Corp. Although a name check on the president of the company, Lons Valor, disclosed that he was charged in France with fraud and embezzlement of public funds, he was granted a license anyway. What were your findings in this case?

Mr. RANDOLPH. Well, as you say, we stated before that he was wanted in a number of European countries for various check-writing scheme frauds. The General Counsel has to make a decision on that, whether or not there is sufficient evidence there to eliminate the person from the program for character reasons. They made that decision at that time that there wasn't sufficient evidence to eliminate him from the program. Eventually, the company has been eliminated from the program and has surrendered their license, but mainly because we found that the company was not in a good financial condition. I guess what the General Counsel is saying is that he was not really convicted of anything and those things that he was convicted of happened a long time ago, and therefore there wasn't sufficient reason. I cannot answer for the General Counsel except that those are the reasons that they gave us.

The CHAIRMAN. During the past year, how many cases were referred to the Department of Justice for investigation?

Mr. RANDOLPH. I will have to ask my staff.

He said six, approximately six.

The CHAIRMAN. That was during this entire year?

Mr. RANDOLPH. This past year, the past fiscal year.

The CHAIRMAN. The past year. We are talking about 1981?

Mr. RANDOLPH. Fiscal year 1982.

The CHAIRMAN. Fiscal 1982?

Mr. RANDOLPH. Fiscal 1982, yes, sir.

The CHAIRMAN. Fiscal 1982.

Mr. RANDOLPH. I would like to supply that figure accurately for the record.

The CHAIRMAN. Yes, why don't you supply that for the record, but that seems a rather small amount when set next to the 42 percent significant violations.

Mr. RANDOLPH. Well, there is a difference between the violations and criminal acts. Most of the referrals are criminal acts that usually involve fraud and manipulation of capital. The examples in my statement were those of outright fraud. Violations are caused by not following regulations. They have not tried to conceal it. It is there to see.

The CHAIRMAN. All right. I might have further questions to submit for a response to the record. We have further witnesses who are now going to appear before the committee. I would appreciate it if you and those with you from your office would stay in the hearing room, in case there might be further questions that I might have of you based on the testimony that the committee receives.

Mr. RANDOLPH. Yes, sir.

The CHAIRMAN. Thank you very much.

[Subsequent information was received and follows:]

U.S. Small Business Administration
Washington, D.C. 20416

OFFICE OF THE
INSPECTOR GENERAL

January 19, 1983

Honorable Lowell P. Weicker, Jr.
Chairman, Committee on Small Business
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

During the hearings of December 16, 1982, I stated that I would furnish for the record an accurate figure in answer to your question as to how many Small Business Investment Companies (SBICs) were referred to the Justice Department in Fiscal Year 1982.

I had indicated during the hearings that this Office had referred six SBICs to the Justice Department. Upon closer review of our records, the accurate number of referrals is five. The sixth case we referred to the Justice Department involved the attorney of one of the five SBICs which we had previously referred to Justice.

If you have any questions or need any additional information, please advise.

Sincerely,

Raymond F. Randolph
Acting Inspector General

The **Chairman**. The next witness is Mr. Felipe De Diego, president of the Feyca Investment Co., Coral Gables, Fla.

Mr. De Diego, do you swear to tell the truth, the whole truth, and nothing but the truth, so help you God?

Mr. **De Diego**. I do, sir.

The **Chairman**. Please be seated. Would you introduce those accompanying you to the witness table?

Mr. **De Diego**. This is Mr. Dana Brigham, my lawyer, from Brigham & Brigham, and Mr. Armstrong. He is——

Mr. **Brigham**. Mr. Armstrong is in my office. He is a retired FBI agent, specializing during the course of his distinguished career in investigative accounting. He helps me to gain a whole picture of matters that come through my office, and in this case over a period of about 12 years on and off I have represented Mr. De Diego.

The **Chairman**. Mr. De Diego, while testifying before this committee, I want you to understand both your rights and your obligations.

You have the right to be represented by and to consult with an attorney while testifying. If you are represented by counsel, he may sit with you at the witness table so you may consult with him. You have already stated the name and address of your counsel for the record.

If you do not invoke any constitutional privileges against testifying, you should also understand that anything you say while testifying before this committee is a matter of public record and can be used against you in any other proceeding. I would also like to advise you that as a sworn witness, subject to the law and penalties of perjury, you are obligated to testify truthfully before this committee.

Do you understand your rights and obligations as a witness?

Mr. **De Diego**. I do, sir.

The **Chairman**. In my opening remarks, I outlined the purpose of our hearing today. The committee's oversight inquiry into the SBIC and MESBIC programs and the committee's power to conduct such investigations is inherent in the legislative process. That power is broad, and one which this committee has in the past and intends in the future to exercise.

Our purpose in meeting today is to take a good, long look at these two programs to get a better understanding of the abuses that have existed, the outlook for the future, and possible legislative remedies.

You may now go ahead and proceed with any opening statement that you might have, and then after that the committee will proceed to questions.

STATEMENT OF FELIPE DE DIEGO, PRESIDENT, FEYCA INVESTMENT CO., CORAL GABLES, FLA., ACCOMPANIED BY DANA BRIGHAM, ESQ., AND ANDREW ARMSTRONG

Mr. **De Diego**. We are appearing only to please the committee, and we brought almost all our records to go through everything that the committee wants to know.

The **Chairman**. All right. We will start off on the questioning. I notice that a vote is taking place, and I will have to apologize for interruption at such time as I have to go to the floor, but we will go as best we can.

As the president and director of the Feyca Investment Co., which was licensed as a MESBIC on August 30, 1979, you received $1.5 million in funding from the Federal Government. The Inspector General's Office, in an extensive audit, has determined that after obtaining majority control, you began spending the money immediately on a lavish lifestyle. You misused more than $132,000 of Feyca's funds for personal expenditures for yourself, your family, friends, and other individuals who have no relationship to your company's business operation.

Included in these personal expenses were costs related to a yacht, jewelry, automobiles, travel to foreign countries, and political contributions. Do you admit that the Inspector General's findings are accurate and that you charged these purely personal expenses to Feyca?

Mr. De Diego. No, I don't.

The Chairman. Well, why don't we go over those matters on which you used the moneys, and maybe you can explain as to how they tie into the operation of the SBIC.

Using company funds, you purchased a 1982 Cadillac for $25,000, a 1981 Ford station wagon for $7,000, and a DeLorean for which you traded in a company-purchased Corvette. How were these cars used in the operation of Feyca?

Mr. De Diego. Well, the Cadillac, I used that car on my own. The Corvette that later on was traded in, is used for the treasurer and the secretary of the company. The Ford, the station wagon, 1980, that doesn't belong to Feyca. That was something that we decided to buy in the name of Feyca back in 1981, and then instead of that we did not buy the Ford and we bought the Cadillac.

The Chairman. All right.

I intend to go down to the floor to vote. We will recess the committee for 5 minutes while I do that, and then I will be right back. This committee will stand in recess for 5 minutes.

[Recess taken.]

The Chairman. The committee will come to order.

Mr. Brigham. May it please the committee, I would like to make a statement at an appropriate time, just before we continue.

The Chairman. Counselor, you go right ahead and make any statement you want.

Mr. Brigham. I have had approximately 2 days in a busy schedule to really get into this matter. There are certain things here that I am not familiar with. On those things, I am going to have to advise my client to take the fifth until such time as I have an opportunity to get into it. The subpena is almost less than a week old, if I remember the dates.

We came here to make a full disclosure. I believe that we can do that. If we can in some measure come back to the committee on these things that we take the fifth on now, we are happy to do that.

The Chairman. Let me say this, that this committee is not convened for the purpose of either embarrassing witnesses or coming away with no information that would assist it in its legislative responsibilities. If indeed the situation is as you describe, then the

Chair would probably have to state that it would be the inclination of the Chair to recess this portion of the hearings and recall the witness, in order to allow counsel more time to meet with his client.

Now just prior to the vote I asked a question relative to expenses and what was paid for what. The response of your client was in conflict with his response at an earlier date to both investigators of the Small Business Administration and investigators of this committee, and it would be my intention now to go on a line-by-line basis with your client.

I repeat, if indeed that is going to result in your perfectly proper advice to your client to take the fifth, then really this would not be a very productive session and it would be my advice that we return at a later date, which I might add is not next year. It would probably be some time in the end of January, upon the reconvening of the new Congress.

Mr. **Brigham**. We would accept that.

The **Chairman**. Therefore, why don't you tell me, counselor, what it is you want to do, because as long as I chair this committee fairness will always prevail, while at the same time pursuing the ends of the committee in a straightforward way.

Mr. **Brigham**. Of course, sir. We would accept the invitation to return in January, at a time of convenience to the committee, and we would prepare ourselves for that. It would certainly give me an opportunity to take a very close look at the situation, even including the fact that the holidays are intervening, and we would come back prepared.

We have certain matters dealing with former accountants and the treatment that they have given, that I need to really take a closer look at, but for the purposes of this morning I thought that that might be sufficient. However, I can see very clearly that I need to get my head further into this matter, and come back to the committee in January and be fully prepared.

The **Chairman**. All right. The witness will then be excused. The committee will hear the witness' testimony the first week in February, and counsel for the committee will be in touch with you, counsel, to give you the exact date but it will be the first week in February.

Again, may I apprise you of the fact that the committee was not satisfied with the first answer and was prepared to pursue this in detail, and that will indeed be the first line of questioning that occurs at the time the committee reconvenes.

Mr. **Brigham**. Yes, indeed.

The **Chairman**. OK, the witness is excused.

Mr. **Brigham**. Thank you, sir.

The **Chairman**. The next witness will be Mr. Murray Reese, a special investigator for the Small Business Administration.

Mr. Reese, do you swear to tell the truth, the whole truth, and nothing but the truth, so help you God?

Mr. **Reese**. I do, sir.

The **Chairman**. You may be seated. Identify yourself and proceed to recite to the committee the results of those investigations of the First Capital Corp. of Fort Worth, Tex., with which you were involved.

STATEMENT OF MURRAY REESE, SPECIAL AGENT, SMALL BUSINESS ADMINISTRATION

Mr. REESE. My name is Murray Reese. I am employed by the Small Business Administration as a special agent. At the time of the investigation of First Capital my title was financial investigator.

I made an investigation of First Capital Corp. To give a little background, if I may, concerning that company, First Capital Corp. was chartered in the State of Texas in May 1960 and licensed by SBA as an SBIC in September of the same year. In May 1975, control of First Capital was assumed by Messrs. John Payne and Harry Scaling, and the offices moved from Waco, Tex., to Fort Worth, Tex.

This case was referred to the Investigation Division of Small Business Administration by the Compliance Audit Division of Small Business Administration because of some questions which arose during the periodic audit by the Compliance Audit Division. The scope of the investigation was primarily concerned with the source of funds for claimed private capital increases and control exercised over borrowers by the SBIC. The investigation was initiated in September 1980, and field work was actually commenced approximately the first week in November 1980.

Approximately the last week in December 1980, the SBIC issued a check to SBA to repay all moneys owed, and asked that they be removed from the SBIC program.

The investigation disclosed that there were three reported private capital increases subsequent to the purchase by Mr. Payne and Mr. Scaling. The beginning capital, as represented, was $300,000. In August 1976, after their purchase, there was a claimed capital increase of $195,000. In November 1978 there was a claimed capital increase of $300,000, and in July 1979 another claimed capital increase of $125,000, making a total of $920,000 plus a paid-in surplus, or a total capital representation to SBA of private capital of $1,310,000.

We looked, I looked at the claimed capital increases of $195,000, of $300,000, and $125,000, those claimed increases that were subsequent to Mr. Payne and Mr. Scaling purchasing the company, and I have some charts that would probably better illustrate, sir.

This first chart represents the August 1976 claimed capital increase of $195,000. Our investigation disclosed that First Capital—this represents First Capital—our investigation disclosed that First Capital issued a check out of their account at the Bank of North Texas to a firm known as Regional Manufacturing Co., on August 27, 1976, for $40,000. This was represented to the SBA as a loan which was made originally and the funds were going to be used for the purchase of equipment, and then repaid on a short-term basis.

The check was deposited by Mr. Lee McCleary of Regional Manufacturing in the same bank which it came out of up here, a different account in the same bank. The check was deposited August 30. On that same date, August 30, Mr. McCleary issued a check on his account at the Bank of North Texas for the purpose of purchasing a cashier's check made payable to Mr. Scaling. That check was deposited into the same account at the Bank of North Texas that it came out of on August 30. There, some 3 days after this was purchased, it was represented as part of the $195,000 capital increase, private capital increase.

The **Chairman**. Just keep going. It is interesting.

Mr. **Reese**. The next reported capital increase was in November 1978, represented to the Government as a $300,000 private capital increase. At the same bank, the Bank of North Texas, Mr. Payne issued one check dated November 13, 1978, and payable to DATCO Construction Co., of which Mr. Charles White is the principal. The same date, November 13, 1978, there was another check that was issued by this bank and payable to W&S Construction Co. These moneys were represented to the SBA as for the purchase of gas and oil properties by DATCO and W&S.

These moneys were taken by Mr. White and deposited into a third account in Madill, Okla., to White Construction Co. On November 16, 1978, Mr. White issued a check payable to Mr. Scaling for $225,000, which was deposited into the same account that the $50,000 and $175,000 came out of, and represented as a part of a $300,000 private capital increase.

The **Chairman**. $50,000 went to DATCO——

Mr. **Reese**. Yes, sir.

The **Chairman** [continuing]. And $175,000 went to W&S Construction?

Mr. **Reese**. Yes, sir. Both of these companies are controlled by Mr. Charles White.

Mr. White deposited both the $50,000 and the $175,000 into a third account that he also had at a bank in Oklahoma in the name of White Construction Co., and on November 16—this transaction was dated the 13th—on November 16, 3 days later, he issued a check to Mr. Scaling which was deposited back into First Capital's account and represented as part of the $300,000 private capital.

The **Chairman**. In the course of your investigation, both in the previous case and this case, did you ask that individual as to why they—in this case White, and in the other case I forgot what the person's name was——

Mr. **Reese**. Yes, Mr. McCleary.

The **Chairman** [continuing]. Did you ask them why they paid the money back to First Capital Corp.?

Mr. **Reese**. Yes, sir. Mr. McCleary stated that Mr. Scaling had been his banker in the past, and that Mr. Scaling had told him that he was going to pay some notes on short-term debts that he owed for $40,000, but he found out later that that had not occurred.

Mr. White said that he had borrowed the money with the anticipation of using it in the oil and gas businesses he had indicated originally, but that he had decided to buy a firm known as—the name escapes me—a firm, a shell company owned by Mr. Scaling, for the $225,000. He found later, because the company didn't materialize, that it was only a shell company and it was of no value.

The **Chairman**. OK. Keep going. I am sure there will be more questions but I just want to get the rationale of people turning this money around.

Mr. **Reese**. All right, sir.

The last capital increase reported to SBA was in July 1979, and it was about $125,000. Mr. Payne of First Capital, using a different bank this time, First National Bank, I believe, in Fort Worth, on July 9, Mr. Payne issued a check payable to R. F. Needham & Associates for $130,000, which was deposited into another bank, the Continental National Bank. That same day, Mr. Needham issued a check payable to C. Gordon Arnold, Jr., to the estate of C. Gordon Arnold, Jr., for $125,000. Mr. Scaling was trustee. I am told that C. Gordon Arnold, Jr., was a deceased person, and Mr. Scaling was trustee for the estate of his deceased uncle.

On the 10th a check was issued by Mr. Scaling as trustee from the C. Gordon Arnold, Jr., estate payable to H.P.S., only the initials H.P.S. Mr. Scaling endorsed that check and it was deposited in the First Capital account and represented as a $125,000 capital increase.

The CHAIRMAN. Now in this particular case we lost $5,000 somewhere along the way, right?

Mr. REESE. Yes, sir. By the way, Mr. Chairman, I don't recall the exact amount but Mr. Needham's account was very small prior to the deposit of the $130,000. It was very small after the check was issued for $125,000.

The CHAIRMAN. Is that Mr. Needham there in the first green box?

Mr. REESE. Yes, sir.

The CHAIRMAN. What did Mr. Needham say was his rationale for turning the money over, the $125,000 over to Mr. Scaling, trustee?

Mr. REESE. Mr. Needham explained to me that he had been planning to buy some real estate from the estate of Mr. Arnold. He had subsequently changed his mind and he considered the debt forgiven. He had an option to buy some real estate but it didn't materialize.

If I may add, the account at White Construction Co., I believe the account balance was some $250 prior to the deposit of the $225,000, and subsequent to it the account balance dropped back to about $220 to $250. For all practical purposes I would consider it dormant.

At this time, sir, we presented the case to the U.S. Attorney in Fort Worth. At the time that we were at this point, we presented the case to the U.S. attorney for the northern district of Texas in Fort Worth. The assistant U.S. attorney that it was presented to asked that we issue our report and any further investigative effort would be conducted by the FBI. This was April 1981.

The report was issued approximately June or July. I do not have the exact date. In October 1982, the U.S. attorney issued a memorandum letter to me. He declined prosecution. He concluded that the transactions were fraudulent and misrepresented to the Government. However, he declined prosecution, he said, because the funds had been repaid to the Government and therefore the Government had not received any loss, any harm to the Government. He said, second, that it was a complex case and it would be difficult for a jury to understand, and the chances of the subjects receiving any substantial punishment would not be too great. Based on that, he declined prosecution.

The CHAIRMAN. Now the U.S. attorney for the northern district of Texas was Mr. James Rolf?

Mr. REESE. Yes, sir.

The **Chairman**. The letter to you was signed by Mr. R. H. Wallace, Jr., the assistant U.S. attorney?

Mr. **Reese**. That is correct, sir.

The **Chairman**. To your knowledge, did Mr. Rolf have any history of association with Mr. Payne or Mr. Scaling?

Mr. **Reese**. When I interviewed Mr. White, Mr. Rolf accompanied Mr. White to the interview. When I interviewed Mr. Needham, Mr. Rolf was present. I do not know that he was representing First Capital. I do not know if he was representing those individuals.

The **Chairman**. Was he the U.S. attorney for the northern district of Texas at that time?

Mr. **Reese**. No, sir. That was prior to his appointment. He was in private practice at that time.

The **Chairman**. Therefore, you do not know whether he was representing them but you do know that he was accompanying Mr. Needham and Mr. White.

Mr. **Reese**. Mr. Needham, yes, sir.

The **Chairman**. This letter declining prosecution, signed by Mr. R. H. Wallace, was from Mr. Rolf, the U.S. attorney for the northern district of Texas?

Mr. **Reese**. That is correct, sir, signed by Mr. Wallace.

The **Chairman**. Well, there is no way that either you or I are going to resolve it. Clearly on its face there is a matter of conflicts here. It would certainly seem to the Chair that it would have been proper for Mr. Rolf to recuse himself from any decision in this matter, and I would ask counsel for the committee to turn both the facts and the letter over to the Justice Department for their determination as to whether or not any further action is in order.

Do you want to proceed? In other words, do you have further——

Mr. **Reese**. That concludes my statement, Mr. Chairman.

The **Chairman**. Now these matters were also turned over to the Small Business Administration?

Mr. **Reese**. That is correct, sir.

The **Chairman**. What actions did they take?

Mr. **Reese**. I do not know. I understand that subsequent to the initial attempt to repay the funds, that the SBIC did in fact repay the funds to the Federal Financing Bank and that they attempted to surrender their license and be removed from the program. My understanding is that at that time the license was not accepted until the completion of the investigation, but I do not know the current status.

The **Chairman**. Is this something Mr. Randolph can respond to or is this something that I should be asking someone else in the administration? Is Mr. Randolph here?

Mr. Randolph, can you respond to my question as to what action was taken on the basis of Mr. Reese's investigation?

Mr. **Randolph**. I have the information here but I have to check it. In December 1980 they did surrender the license and they returned the funds to the SBA.

The **Chairman**. When was the investigation commenced?

Mr. **Reese**. The field work was commenced in November 1980, sir.

The CHAIRMAN. The field work was commenced in November 1980. Mr. Randolph, to the best of your knowledge they offered to return their license when?

Mr. RANDOLPH. December 1980.

The CHAIRMAN. A month after the investigation started. Am I correct?

Mr. REESE. Approximately 2 months, sir. I think the field work started November 1, and I believe their offer to surrender the license was the latter part of December.

The CHAIRMAN. Mr. Reese, I have no further questions at this time, if you would remain in the room while we question the other witnesses.

Mr. REESE. Thank you, sir.

The CHAIRMAN. It will be the intention of the committee to ask Mr. Scaling and Mr. Payne to be the next witnesses of the committee. The committee will now stand in recess while I go downstairs and take care of this vote.

[Recess taken.]

The CHAIRMAN. The committee will come to order.

Mr. Payne and Mr. Scaling, do you swear to tell the truth, the whole truth, and nothing but the truth, so help you God?

Mr. PAYNE. Yes.

Mr. SCALING. I do.

The CHAIRMAN. Thank you very much.

Mr. Payne and Mr. Scaling, while testifying before this committee I want you to understand both your rights and your obligations. You have the right to be represented by and to consult with an attorney while testifying. If you are represented by counsel, he may sit with you at the witness table so that you may consult with him.

Is this your counsel that you have with you? Would you identify yourself, counsel?

Mr. MCSPEDDEN. Yes. R. L. McSpedden, practicing law in Dallas, Tex.

The CHAIRMAN. Thank you very much, Mr. McSpedden.

If you do not invoke any constitutional privileges against testifying, you should also understand that anything you say while testifying before this committee is a matter of public record and can be used against you in any other proceeding. I would also like to advise you that as a sworn witness subject to the law and penalties of perjury, you are obligated to testify truthfully before this committee.

Do you understand your rights and obligations as witnesses?

Mr. PAYNE. Yes.

Mr. SCALING. Yes.

The CHAIRMAN. Now, counsel, do you have anything or do your clients have anything to state before I get to the matter of questions.

Mr. MCSPEDDEN. Your Honor, they could make either a brief opening statement about the matters brought up here or you could question them, whichever pleases the chairman.

Mr. PAYNE. I would like to make a brief statement.

The CHAIRMAN. Both will certainly have the privilege to state whatever they care to on this matter.

Mr. Payne?

STATEMENT OF JOHN R. PAYNE, FIRST CAPITAL CORP., FORT WORTH, TEX., ACCOMPANIED BY R. L. McSPEDDEN, ESQ., DALLAS, TEX.

Mr. PAYNE. Well, it is obvious here that Mr. Scaling and I are being accused of increasing capital to enable us to leverage additional funds. Mr. Randolph, he stated in his example that we embezzled $225,000. We did not embezzle anything.

This was done on a transaction that at the time we felt would benefit all concerned, our SBIC. In our opinion it was a legitimate business transaction. It came under the rules and regs as we understood them. We did have a one-man type operation and it is very difficult for a one-man operation to keep up with all the rules and regs.

Nevertheless, at that time we felt that we had not done anything wrong. Specifically he named a $225,000 transaction. I just ask the committee where we were helped if we did not get any financing from the time that we did it for over 10 months after that transaction? It does not stand to reason that we needed these funds at that time or even near that time.

Our company has helped many small concerns, some 30-odd concerns. We had some in the portfolio that have done real well. They have hired lots of people. We have had some that have been bad. We have had some that have increased oil and gas reserves when our country needed them very badly.

We had an investigator that, without giving many of these small business concerns an opportunity to produce their records, subpenaed records, substantially hurting them at banks and other lenders, substantially hurting them. There was no reason.

I do not have any other comments. Mr. Scaling and I paid the loan off. Basically, the only one that can lose in this transaction is Mr. Scaling and I. We paid $3 million, and basically we owe a bunch to the bank. We pay an effective rate of over 18 percent and we had an effective rate of about 8.45 percent or somewhere in that neighborhood in the debentures, and we would not have had to pay off the debentures themselves, the principal part, for several years.

You know, at times we did have to exercise control and there were several reasons, but the primary reason is to protect our investment and to protect the Government's investment, which had over $3 million invested here.

With these remarks, since we did not have the opportunity on 2 days' notice to do these elaborate charts, I think Mr. Scaling can probably explain.

STATEMENT OF HARRY S. SCALING, FIRST CAPITAL CORP., FORT WORTH, TEX., ACCOMPANIED BY R. L. McSPEDDEN, ESQ., DALLAS, TEX.

Mr. SCALING. I would like to say, first, sir, that it has been indicated that we paid this thing off because of the investigation. That was not the fact at all.

The reason we decided to pay this off was, in the normal audit which happens every year, around that summer the auditor informed us that we were in serious violation because we had invested our legal limit, $200,000, in a company called Sun Belt Exploration. We had spent the time, money, and effort to secure funding through Denver, SEC funding through Denver. Blinder Robinson did the underwriting. We were under the impression, just like everything else, that we could own 49 percent of the company.

Apparently on a public company you can only own, I think, 20 percent. They said we would have to divest ourselves of that. Mr. Payne and I met and said—we had another one coming with another oil venture—we would get hurt too badly because if we have to go from 50 percent down to 20 percent, after spending all the time, money, risk, and everything, to heck with it. We will just take our lumps, pay off the loan, and goodbye.

Those are my comments. Now I will be happy to explain those transactions, if you would like.

The CHAIRMAN. Well, does that consist of your opening statements? I want to make sure you have every opportunity to——

Mr. PAYNE. Well, I think he should have the opportunity to explain point by point on——

The CHAIRMAN. Believe me, there will be ample opportunity to go ahead and explain those transactions.

The financial investigator for the Office of Inspector General testified that in August 1976, November 1978, and July 1979 you made representations to the Small Business Administration of increased private capital in First Capital Corp. totaling $620,000. He also testified that $390,000 of this amount was not increased private capital at all but funds which originated in First Capital and through circular financing schemes were returned to First Capital's bank account.

Now according to the investigator's testimony, these fraudulent representations of capital allowed you to qualify for a substantial portion of the $3.725 million that you received in loans from the Federal Government. How do you respond to these charges? This will give you the opportunity to go step by step on each one of these matters that was presented before the committee. I wonder if Mr. Reese might put up the first chart? Can you just put up the first chart?

All right. Proceed in any way you want.

Mr. SCALING. This is the $40,000 deal, right? All right. I have loaned Mr. McCleary and his various entities personal money going back to 1970 and maybe before. No telling what it has been because I loan him interim money, he pays me back, and I have helped him in his financing.

This particular deal, on this short notice I just went back to my check stubs and I had loaned Regional Manufacturing personally $70,000, I think, in March or April 1976 of that year. He was putting together an operation in Ennis, Tex. We had agreed that once he got all his equipment, his building, his land together, we would make him a long-term real estate loan because that is going to help him get long-term financing, which he needs, you know, to space out his payments.

Therefore, I said, "OK, I will loan you the money," and then obviously when we put this package together it is just like an interim financing deal. He is going to pay me back just like if he had gone to the bank, he would be paying the bank back. That check was my check from my personal account to First Capital Corp. He very likely paid me $40,000 or something that month, which is fine. He owed it to me. He owes me $40,000, $50,000, $60,000 right now. He is also a year behind in his loan to the First Capital Corp., and we haven't foreclosed or anything on him. He is 1 year behind on his monthly payments. This is a real estate, land and building loan and equipment, and it is certainly worth more than that.

We are personally working with him because he is a good man. He will work 14 or 16 hours a day. He presents a quality product. The State of Texas has awarded him these guardrail deals, for powder coating, you know. He is a good man and we are working with him all we can. That is all I have to say about that one.

Mr. PAYNE. May I make a comment about that? It is not unusual in our situation, it is not unusual for banks and other lenders to do similar things where they go out, they help the man to some degree and once the package is put together, then they fund it. This is not unusual in any financial dealings. The money in question, Mr. Scaling had put the money up.

The CHAIRMAN. All right. Mr. Reese, you may participate in this discussion here, just so that we get all the facts straight.

Now as I understand this, this is a check from First Capital Corp.—is that correct?—to Regional Manufacturing.

Mr. REESE. Yes, sir, that is correct. The check was issued by Mr. Payne, payable to Regional Manufacturing Corp.

The CHAIRMAN. In the amount of $40,000.

Mr. REESE. Yes, sir.

The CHAIRMAN. It was a First Capital Corp. check. Is that correct?

Mr. REESE. That is correct.

The CHAIRMAN. Not an individual check, a First Capital Corp. check for $40,000, issued on August 27, 1976——

Mr. REESE. That is correct, sir.

The CHAIRMAN [continuing]. To Regional Manufacturing.

Mr. REESE. Yes, sir.

The CHAIRMAN. Then on August 30, 1976, $40,000 comes back to First Capital.

Mr. REESE. Yes, sir, into the same account that this check was issued on disbursing it from First Capital.

The CHAIRMAN. Well, I do not understand what this is all about.

Mr. SCALING. I do not understand that. I am just saying that my personal check went into First Capital in August 1976. All Mr. McCleary did——

The CHAIRMAN. I am not interested in the personal check. I am interested in the fact that——

Mr. SCALING [continuing]. McCleary did pay me back $40,000 of the $70,000 he owed me.

The CHAIRMAN. This is not a personal check. This is a First Capital Corp. check. Am I correct on that point?

Mr. PAYNE. That is correct. Absolutely. No question.

The CHAIRMAN. Then 3 days later the $40,000 comes back into First Capital.

Mr. PAYNE. It could have been the same day. I mean, Mr. McCleary, we had already advanced him the money, Mr. Chairman. We were trying to consolidate a loan. We were not trying to hide anything. If Mr. Reese had asked Mr. Scaling, he would have shown him. He never talked to the man.

The **Chairman**. Mr. Reese?

Mr. **Reese**. I have never seen Mr. Scaling.

Mr. **Payne**. That is right.

Mr. **Reese**. I saw Mr. Payne several times and asked him, and he has never offered any explanation for this.

The **Chairman**. If the matter is as you portray it, why then on the books of First Capital did this not appear as repayment of a loan rather than an increase in capital?

Mr. **Payne**. Because Mr. Scaling, when he made the loans back several months—and it was in increments, it might have been $10,000 here, $15,000 here, $20,000 here, or he might have gone to the bank to get it—you know, we did not do it until we just came up to a certain point, and then we booked the loan.

However, Mr. Reese is saying that the funds, that $40,000 was not Mr. Scaling's funds. Mr. Scaling had a lot more in——

Mr. **Scaling**. I have more than that in my bank account. I do not know where he did all this business but I have a check from my personal account to First Capital for $40,000 which they have in their records. I did not bring it because—I mean, that was the investment, out of my account to First Capital.

The **Chairman**. Now let's get one thing clear: As far as I am concerned, I am not going to be in a position to determine which moneys in First Capital are yours and which comes from the taxpayers of this country. There is no way I am going to catch up on that.

You are subject to the rules and regulations of the Small Business Administration, and——

Mr. **Payne**. Mr. Chairman, at the time that that was made we did not even need the $40,000 in there to be still in compliance with the rules and regs. We had not borrowed that much money.

The **Chairman**. I still want to know why a Small Business Investment Company loan goes out on August 27, 1976, and then comes back 3 days later. What is there, in other words, in the nature of the objectives of the SBIC program that is being fulfilled by that kind of a transaction?

Mr. **Payne**. That particular transaction is more of a bookkeeping transaction, so Mr. Scaling can keep up with his investment, First Capital can keep up with the loans that they have. Again, this was not uncommon, to go to a bank and help somebody, one of these small business concerns, and then you come back later and have to pay off the bank, or pay off Mr. Scaling, or pay off me.

Mr. **Scaling**. You see, Regional did owe me the money.

The **Chairman**. It is my understanding from counsel that regulations require that loans be for a minimum of 5 years. Is that correct?

Mr. **Payne**. When we make them, that is correct.

Mr. **Scaling**. Yes, sir. This was packaged eventually in a real estate loan that was for 10 years.

The **Chairman**. Mr. Reese, are there any further comments you have on this case? I want to get to the explanations of the other two here.

Mr. **Reese**. I have no others.

The CHAIRMAN. There is $40,000, however, that has gone out and has been then laundered through, or whatever term you want to go ahead and use, through Regional Manufacturing Co. to come back into First Capital Corp. within a matter of 3 days. I still do not have an explanation that I consider satisfactory.

Mr. SCALING. Sir, I loaned Regional Manufacturing Co. $70,000 several months before.

The CHAIRMAN. You individually or——

Mr. SCALING. Me individually.

The CHAIRMAN. What has that got to do with First Capital Corp.?

Mr. PAYNE. First Capital was going to make the loan eventually, as soon as we got the real estate package put together.

The CHAIRMAN. Therefore, this is just money, in other words, that you are——

Mr. SCALING. This is just interim financing that I did personally, I advanced the money instead of going to the bank.

Mr. PAYNE. We could have gone to the bank.

Mr. SCALING. We could have gone to the bank just as easy but I had the money available, so I did it. We packaged the loan. That loan eventually ends up in a $100,000 real estate loan, 10 years.

The CHAIRMAN. It is your position that the $40,000 aspect of this is what, a repayment to you individually?

Mr. SCALING. Yes. Well, right, it ends up because I made the original advance. Instead of the bank making it, I did. I advanced the money to Regional, so First Capital, when they fund their deal they fund it to Regional and then McCleary pays me back my interim loan.

The CHAIRMAN. Well, why don't we proceed to the other two loans to see whether this is going to be the explanation for all three.

Why don't you go ahead and explain this one?

Mr. SCALING. All right, sir.

This particular deal was, Mr. White had a party called Wymont Oil Corp. in New Mexico. I own a little public shell in Midland, Tex., that they wanted to utilize, put a couple of these SBIC companies, purchase them and put them in there, utilize that public shell.

Therefore, I told him that everything was fine but I had a lawsuit, a big lawsuit against the First National Bank of Midland, and the funds were in court, and I could settle that for something in the neighborhood of $200,000. Therefore, we entered into a contract. These people were willing to put up the $225,000—this company also had about close to $500,000 tax loss carryforward in it—to utilize this as a holding company type deal for several companies.

Therefore, he entered into a contract with me to purchase BP Industries for $225,000. He issued a check to me, and I just endorsed it over to First Capital because I had agreed that any of this money that I had accumulated from these investments, it is just merely utilizing an asset and putting it someplace else. I went immediately, that day, out to Midland to settle this deal with First National Bank of Midland, which I did, and fulfilled my end of the contract.

The CHAIRMAN. Mr. Reese, do you have comments to make on this transaction?

Mr. Reese. No, sir. This represents a loan to DATCO for gas and oil exploration. I believe this was represented as a loan to W&S Construction, with Mr. White.

The Chairman. Again, the loan was from First Capital to DATCO on November 13, 1978, and was it then 2 days later——

Mr. Reese. The same day as the loan to W&S Construction.

The Chairman. The same day, November 13, to W&S.

Mr. Reese. Yes, sir.

The Chairman. Then 2 days later in the case of DATCO and—what—3 days later they both——

Mr. Reese. There were funds deposited to——

The Chairman. Two days later the moneys were payable to White Construction?

Mr. Reese. That is correct, sir. They were deposited into another company, and Mr. White controls all of White Construction Co. Then a check was issued to Mr. Scaling and went back into the same account.

The Chairman. Again, the total elapsed time there is 3 days.

Mr. Reese. That is correct, sir.

The Chairman. Well, I still don't understand here what this has to do in terms of the objectives of the Small Business Investment Company program in the sense of a 3-day turnaround of money here.

Mr. Scaling. Well, you know, that is up to White. We had agreed to loan White the money. He is in the real estate development business up in Oklahoma. We had another company that was in a similar business, and he was working with this other company. We loaned him that money.

Apparently this deal came up on this Wymont deal, and I feel like he apparently wanted to use those funds for his benefit to make his deal with Wymont. I imagine that Wymont, I assume, reimbursed him for his—you know, he closed this deal for Wymont, and I assume they sent him a check reimbursing him.

Mr. Payne. They did. I have a check here that they had given him, and that is where everything cratered because it bounced. He did have a bunch of oil and gas properties that were put up for collateral.

There is one thing, though, a good point that I would like to make here again on that particular transaction. That happened on November 13, 1978. We had at that time outstanding—I am not positive, but we were still way under what we normally could borrow from the Government. We did not go out and all of a sudden borrow a bunch of money from the Government because we put $225,000 in there. We weren't even close to it. We had somewhere in the neighborhood of, I think, $900,000 of positive leverage if we had gone to get it, and why would we go out and do something like that? Here are two people who can go borrow $3 million from the bank. We can surely go borrow $100,000 from some bank to put in there and increase capital.

The Chairman. If you actually made these loans, they would have to be on the annual statement for this period to SBA; would they not?

Mr. Payne. Well, the fiscal year, sir, is March 31. Again, I had 2 days' notice to come up here and I did not bring all the records but

I can tell you this: Whether or not that thing was going to go or did not go, we had 5 months to find out, and apparently it did not. We had the oil properties and they went into another company.

The CHAIRMAN. That is your reasoning for why they were not listed on the certified financial statement you submitted to SBA?

Mr. PAYNE. They were not on it, no, sir. They should not have been on the financial statement at March 31 of that particular year, because they went out.

The CHAIRMAN. Were they on a subsequent statement?

Mr. PAYNE. No; they would not be because we did not have any financings or anything. The time that you send the reports in, sir, is at the time, at the end of your fiscal year you have a certain amount of time to do it. We complied with that. They were off.

If we had had a funding in between, between November and March 31, certainly they would have been on that but we did not have any fundings for several months. We are talking about 10 months down the road before there was even another funding. Now why do we need the money? We had, at the time, I had $150,000 in cash in the bank. We had also about $900,000 worth of leverage due us. Why did we have to do that?

The CHAIRMAN. Well, that is between you and the Small Business Administration, to which you were indebted some $3 million, so——

Mr. PAYNE. Let me tell you, Senator, the reason that we did things like this, we were trying to protect our investment. We were trying to protect the Government's investment, and there are a lot of these people that have defaulted on loans. We have not defaulted on anything; never did we default. We were timely on every payment to everything. We were responsible. We had a bunch of good loans to SBC's, and I do not see anything wrong with that.

We might have made some mistakes. There is no question about that. As I said, a one-man office cannot run it like a bank can.

The CHAIRMAN. What did this transaction have to do with BP Industries?

Mr. SCALING. BP Industries is a public shell which Wymont was going to acquire to put, to utilize BP as a holding company to put several companies into. I own 80 percent of BP Industries.

Mr. PAYNE. That was public, and it was more than a shell. There were a lot of good assets in that company.

The CHAIRMAN. SBA regulations require SBI financings be for a minimum of 5 years. How did the purchase of shares in your company, BP Industries, by Mr. White relate to the operation of First Capital?

Mr. PAYNE. Sir, at the time, BP Industries was the key to Mr. White making the Wymont Oil transaction. The only way he could make it was to get a public corporation, to put their enormous assets in that public shell. Obviously we were very interested in anything public because it helps First Capital's liquidity position, so we were very anxious.

The CHAIRMAN. I will tell you, watching the way you fellows operate, my concern is not about the liquidity of First Capital Corp. That is about the most liquid thing I have seen out here.

SBA regulation 107.1008(b) prohibits conflicts of interest which allow companies or individuals associated with the SBIC to personally profit from a financing. Since you personally profited from the sale of your company, BP Industries, to Mr. White, which had nothing to do with the operation of First Capital, would you agree you violated the conflict of interest regulation?

Mr. **Payne**. I do not think so.

Mr. **Scaling**. No. The deal was with Wymont Oil Co., not with White. White was just merely their agent but we did not profit anywhere.

Mr. **Payne**. Yes, how did we profit? That is what I do not understand.

The **Chairman**. Mr. Reese, would you like to comment on that?

Mr. **Reese**. As best as I can, the loans made to Datco and to W&S Construction, Mr. White was the party, the principal in those, and those funds in turn went back into First Capital's account, went back into the same account. They just took this form to get there, and Mr. Scaling made a profit by selling the public shell of BP Industries.

Mr. **Scaling**. You know, I still own BP Industries, 80 percent, just because they could not perform under this contract. Wymont could not perform.

Mr. **Payne**. You know, Mr. Reese and the FBI and other interested parties here, they got full statements from Mr. Needham, from White and all of them. I do not think those statements deviated any from what we are telling. All we can do is to come up here and try to tell the truth, and so they are. Some of these things are very complicated. It is hard for Mr. Reese and me, I mean, 5 years later to come back here and try to explain things.

However, there wasn't anything dishonest or anyplace that we were going to benefit out of it, other than we were trying to protect our investment and the Government's investment.

The **Chairman**. On November 20, 1978, you reported this $225,000 as part of a private capital increase of $300,000 to SBA. Wasn't this $225,000 simply the same money that you had given to White 1 week earlier, and not an increase in FCC's private capital?

Mr. **Scaling**. Our deal was with Wymont Oil Corp. Where White got the money, I do not know. We assumed or I assumed that Wymont was supplying him with the money. They are the ones that wanted to buy the company.

Mr. **Payne**. There was the check they put in escrow.

Mr. **Scaling**. You know, here is the check. We tried to send it through——

The **Chairman**. Besides this $225,000, did any other money in fact go from Mr. White directly back into First Capital's account?

Mr. **Payne**. I do not recall. I do not know. He had a few checks that bounced or something when he was trying to pay it.

You would know, Mr. Reese.

The **Chairman**. Therefore, you not only received $225,000, First Capital, a Government-funded company, you claim to have also received oil leases—is that correct, Mr. Scaling?—as a part of the deal.

Mr. **Scaling**. No. On White's loan we accepted some oil leases in payment back to First Capital for part of his loan. He still owes

First Capital some money. I forget how much it is, but we accepted a substantial amount of White's loan back in oil and gas leases.

Mr. PAYNE. If Mr. White had kept his oil and gas leases instead of giving them back to us, there would not be any question, really, and White would have been better off.

The CHAIRMAN. Do you know, or have you ever been represented by Mr. Rolf?

Mr. SCALING. I know Mr. Rolf.

Mr. PAYNE. I met Mr. Rolf one time.

The CHAIRMAN. Have you ever been represented by Mr. Rolf?

Mr. SCALING. Yes, we talked with him. He was an attorney there in Dallas.

The CHAIRMAN. I asked you the question: Have you ever been represented by Mr. Rolf?

Mr. SCALING. Yes, sir.

The CHAIRMAN. You have been. Did he represent you in this case?

Mr. PAYNE. I would say he represented First Capital in this case.

The CHAIRMAN. He represented First Capital in this case?

Mr. PAYNE. I do not think he represented Mr. Scaling or I at the time.

The CHAIRMAN. Well, I mean, you are First Capital, aren't you?

Mr. PAYNE. Well, we own the bulk of it, yes.

The CHAIRMAN. Let's go to the Needham transaction.

Mr. SCALING. All right, sir. The Needham transaction——

The CHAIRMAN. R. F. Needham & Associates received a loan from First Capital for $130,000. The financial investigator testified that on the day Needham received the loan, he gave all but $5,000 to the estate of Mr. Scaling's uncle, C. Gordon Arnold. Why did Mr. Needham provide the proceeds of a loan designed to assist small business to a dead man, Mr. Scaling?

Mr. SCALING. That is just a dormant account. It is an estate account, right. It has been there a long time, and there is no activity in it. Needham entered into an agreement with me on a piece of downtown real estate. He is in the real estate business. He had had under option or contract several pieces of property. He was trying to block up a complete block for a substantial transaction.

My little building is the only outlet to Houston Street and he needed that. He was trying to put a parking lot deal together, I think, or that is what I understand, and he needs that outlet to Houston Street. Therefore, I told him there were several people interested in the property, and I said, "I am not going to take less than $125,000 for it. What I will do, if you will put the money up I will turn the deal over to you and in fact give you an option to turn your deal for the $125,000, but I am not going to dicker on the price."

It happened that about a year and a half later this deal fell through and he could not perform. A year and a half later I was offered $250,000 for the property and I turned that down. It was kind of a dead property at that time and it has become valuable. He had a good idea. He just could not perform. He had some problems with his other contract and he could not perform on his deal.

The CHAIRMAN. Well, aren't real estate transactions prohibited under SBA regulations? Isn't this a prohibited transaction, even if it had gone through?

Mr. PAYNE. I do not believe it is, sir. I think you can have a certain percentage of your loans. I may be wrong, and again this goes back to not being as well versed, probably, as I should be. He was in the real estate development business, and I do not——

The CHAIRMAN. Isn't there some sort of conflict of interest here, as between Mr. Scaling and his uncle or his uncle's estate?

Mr. SCALING. No, that is just merely an account. I control that account. It is just like an escrow account. That is just an account I put it into over here until this deal either closes or does not close.

Mr. PAYNE. However, let me make a remark here, because I do not think you do understand this: Mr. Needham, after a few months, when the deal did not go through Mr. Scaling had to reimburse those funds and pay back First Capital for that loan. This was before; this was not out but maybe a year at the most. He repaid the funds himself, personally, before we ever even heard that there was an investigation. We were trying to be straight in this.

The CHAIRMAN. Let me say that I am not impressed by that because I question the whole transaction as being improper under the rules and regulations of the Small Business Administration for the SBIC program.

Mr. PAYNE. Well, it is my understanding——

The CHAIRMAN. The fact that it fell through or that you did not know about an investigation does not have any bearing on this case at all.

Mr. PAYNE. It is my understanding that you can invest in real estate.

The CHAIRMAN. Let me tell you what I am seeing. Wait a minute. I intend to turn these matters over, I might add, to the appropriate authorities. Obviously I think there has been a serious conflict of interest—and I am just using the kindest phrase possible—as between yourselves and the U.S. attorney. I intend that these matters, in other words, be referred once again to the Small Business Administration for disposition through the Justice process.

However, I am getting a picture here very clearly of two individuals that are using the SBIC program in any way they deem fit for their personal advantage, not being subject to any rules and regulations, or any prohibitions, or any restrictions. I do not have the capacity, admittedly, sitting here as a chairman, to go through all these individual transactions and estate transactions and First Capital Corp. transactions and arrive at a proper conclusion. However; I do not think what I see here before me is what was intended by the SBIC program as legislated by the Congress of the United States.

I think you have had a great field day with this thing. I think probably now that somebody is coming along and saying that you have to go ahead and play within the rules, you do not want to be part of the game. Even at that, you went ahead and made a good amount of money. Do you want to go ahead and tell this committee as to the amount of the discounts that you got from the Federal Financing Bank for the early payment of your debt?

Mr. **Payne**. I think you have the figures there, Mr. Chairman. I don't——

The **Chairman**. I sure do; $681,000. Don't sit here and say that nothing came out of the pockets of the taxpayers and this was all a gratuitous action on your part. You had a clear financial gain in the sense of what you did. What I am going to do is to make sure you are held accountable for what it is you did do. I have never seen such a mess in my life, which clearly was meant to go ahead and benefit the two of you.

This program was meant to benefit the small business community, to make sure that funds were available for the small business community in the sense of starting businesses, not just putting dollars in your pocket.

Mr. **Payne**. Mr. Chairman, may I just make one remark? At the time we——

The **Chairman**. In all three of these circular transactions, the largest period that any of the $390,000 was away from First Capital was for a period of 5 days.

Mr. **Payne**. Mr. Chairman, I was under the impression that we were going to have the courtesy to respond to some of these things.

The **Chairman**. You have been given plenty of opportunity to respond, and you will be given more opportunity to respond. I would like to know how these types of transactions fulfill the congressional intent to make long-term loans to small businesses, and given the SBIC regulations that require financing to be for a minimum of 5 years. Now how do you give any legitimacy to these types of transactions?

Mr. **Payne**. Well, first of all, we made 30-some-odd transactions so they are not all——

The **Chairman**. Now are you talking about ones outside of this?

Mr. **Payne**. Yes.

The **Chairman**. Well, I am not talking about those. I am talking about these. Is there some reason why you get a sort of an exemption here on *x* number of transactions from obeying the law, and that makes it right, in other words, as long as you do well on the others? Not so in my book.

Mr. **Payne**. You mention the fact that we profited from the early payoff, et cetera.

The **Chairman**. Yes.

Mr. **Payne**. You know, we had nothing to do with that. When we sent the check, we sent the check for the full amount of those debentures.

The **Chairman**. I am sure you knew what you were doing. You mean you knew nothing about rebate provisions for early payment when you sent that in?

Mr. **Payne**. At the time I was not sure what they were. I could not decipher what the rules and regs were.

The **Chairman**. Mr. Randolph is here. Mr. Randolph, what is the position of the Inspector General's Office on these matters at this time?

Mr. **Randolph**. What matters are you talking about?

The CHAIRMAN. I am talking about the ones that have been discussed here, both by the investigator and by Mr. Payne and Mr. Scaling. These matters, in other words, are they within the purview or within the responsibilities of your office?

Mr. RANDOLPH. The U.S. attorney has declined prosecution. There is nothing much more we can do about it, sir.

The CHAIRMAN. If you received a letter from this committee requesting that these matters be once again referred to the Justice Department, is that something you could comply with?

Mr. RANDOLPH. Yes, sir.

The CHAIRMAN. Well, it will be the intention of this committee to make that request.

Now if you have anything further in the way of additional explanations, please go right ahead.

Mr. MCSPEDDEN. Mr. Chairman, would I be permitted to make a brief statement?

The CHAIRMAN. Counsel, you go right ahead.

Mr. MCSPEDDEN. I am somewhat concerned about the discussion of the U.S. attorney's office in the northern district of Texas, and I am familiar with and know the surrounding facts about this matter.

I was employed by Mr. Payne and Mr. Scaling back when this thing first came up, and I talked to them about the payoff of this note. They told me that they were going to get out of the thing anyway. I said, "Fine, let's pay it off." I calculated on these debentures what was due the Government, and told them to go get a check and mailed it up to Washington. I will tell you it came as a total and utter surprise to me when they said, "No, you do not owe us that much money." I read the note and calculated the interest on it.

Now with respect to Mr. Roth, I employed Mr. Roth to help me in this matter because my expertise was certainly not in any field of criminal law. Mr. Roth was then in the private practice of law. He had once before worked in the U.S. Attorney's Office. Mr. Roth met with Mr. Reese and myself and some of these witnesses. We all went through exactly the long, detailed explanations of what we are trying to tell you here today.

Mr. Roth was appointed as U.S. Attorney for the Northern District of Texas. I do not believe, and it would astound me if Mr. Roth ever had one thing to do with this case since that day. I noticed that he did not sign any such letter, but there is nowhere else that a letter could come out of that office but over his name. A Mr. Wallace in Fort Worth, in a different town, has to the best of my knowledge represented the U.S. Attorney at all times through this thing. I would categorically go on record that I cannot conceive of Mr. Roth overstepping his bounds as the U.S. Attorney.

Thank you.

The CHAIRMAN. Well, that is not for this committee or this chairman to go ahead and decide. All I know is that I have a letter here to which the name of the U.S. Attorney is affixed. Counselor, I think we are both attorneys. We certainly would both agree that this entire matter is one that he should recuse himself of if he had knowledge.

Mr. MCSPEDDEN. I am confident he did.

The CHAIRMAN. That he recused himself?

Mr. MCSPEDDEN. Yes, sir. I am sure that he did not participate.

The CHAIRMAN. Well, as I say, that is not something that you and I can determine. That is something for the Justice Department to determine. Certainly on the face of it, it does not paint a very commendatory picture for the U.S. Attorney from the Northern District of Texas.

I have no further questions at this time. If there are further questions, they will be submitted for response to the record, and the witnesses are excused. Thank you.

Mr. MCSPEDDEN. Thank you.

The CHAIRMAN. All right. We have as our last witnesses, as a panel, we have Mr. Walter Stults, president of the National Association of Small Business Investment Companies; Mr. Robert Zicarelli, chairman of the Northwest Growth Fund; Mr. E. Patric Jones, president of the Urban Fund of Illinois; and Mr. Patrick Owen Burns, president of Minority Equity Capital Co. of New York. Gentlemen, if you will all step up, we will be delighted to hear from you.

I warn you that we have a difficulty on the floor, as you have already seen. I do not want to keep you any longer than has been the case up to this point. May I suggest that all of your formal statements be included in the record in their entirety at this time, and that you proceed in an informal way to give your views as to the program or any other matters that you feel or you deem important to bring to the attention of the committee.

Walter, why don't you go ahead and start off.

Mr. STULTS. Mr. Chairman, I have no formal statement. I am accompanying Bob Zicarelli to help him with any questioning you may have.

The CHAIRMAN. Fine, thank you.

Mr. Zicarelli?

STATEMENT OF ROBERT F. ZICARELLI, CHAIRMAN, NORTHWEST GROWTH FUND, INC., MINNEAPOLIS, MINN., ACCOMPANIED BY WALTER STULTS, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, WASHINGTON, D.C.

Mr. ZICARELLI. Mr. Chairman, I appreciate the opportunity to be here this morning. I am chairman of Northwest Growth Fund, a small business investment company located in Minneapolis which is a wholly owned subsidiary of Northwest Bank Corp., the 19th largest bank holding company in the United States. I am also serving this year as chairman of the National Association of Small Business Investment Companies.

We appreciate the opportunity to discuss our program with you, and despite what you might have heard this morning, we are proud of our industry and of the job we are doing to help the Nation's growth-oriented small business programs.

The CHAIRMAN. Let me ask you one question, and I do not mean to interrupt you in any way. Without getting into the detailed merits, because it would be very difficult without all the facts, are these unusual transactions that I saw here today? Just use that word, "unusual."

Mr. **Zicarelli.** I am just a simple venture capitalist. To me those were very complex transactions. I think there is probably more to it than the—

The **Chairman.** I am not asking you to pass on the correctness of it but I am just wondering whether this is normal. Maybe as one who is outside your industry it seems unusual to me. Is this typical, are these typical transactions to the industry?

Mr. **Zicarelli.** I can assure you they are not typical of the transactions that I have been involved with, nor have the people that I am experienced with.

The **Chairman.** OK.

Mr. **Zicarelli.** Let me just tell you a little bit about the Northwest Growth Fund as some background to my testimony. We were licensed in 1961. We have been wholly owned by Northwest Bank Corp. since 1979. We currently have private capital of $10 million, of which $3 million was paid in and $7 million was capitalizing retained earnings in our business.

We currently have $23 million of SBA debt. We have total assets at market value of some $75 million, which have a cost basis of around $36 million. Our company is headquartered in Minneapolis, Minn., as I said earlier, and we have branch offices in Denver, Colo., and Portland, Oreg. We have invested some $65 million since 1961, and provided substantial management counsel to some 150 small firms. Our current portfolio consists of some 70 businesses. Our portfolio is somewhat unique because of its diversification. We have a substantial number of investments in Minnesota, but because of our branch office operation we have investments in some 16 States in addition. Our portfolio is also characterized by a wide diversity in types of firms in which we have made investments. Included in our portfolio are some high-tech businesses, such as Cray Research, which was mentioned earlier by SBA, which is the builder of the world's largest scientific computers; Molecular Genetics, a genetic engineering firm which recently received publicity for a herpes vaccine it has identified; and some more mundane companies such as Vee Corp., which produces the roadshow version of "Sesame Street," and Minnetonka, Inc., which makes soft soap.

Because we strongly believe in the contribution of SBIC's to the areas we serve, we in recent years made our own economic impact survey and we think the results demonstrate the value of the program. For example, we have some 52 companies in our portfolio which we surveyed as of December 31, 1981, and those companies showed some sales increases of over 300 percent since we invested in them, and they have shown employment gains of nearly 9,000 new jobs since our original investment. Taxes paid in the most recent year were $68 million versus $20 million before we got into them. That $48 million difference paid in 1 year is more than twice the SBA's debt we have in our company.

At this point in our remarks, I shall include a table showing the economic impact of Northwest Growth Fund's investments on the small firms which were in our portfolio on December 31, 1981.

[Material follows:]

NORTHWEST GROWTH FUND, INC.

Economic Survey

The following economic survey was completed for small business companies in Northwest Growth Fund's portfolio as of December 31, 1981

		Fiscal Year Before Initial NWGF Financing*	First Fiscal Year Following Financing**	Total of Columns 1 and 2	Most Recent Fiscal Year
	Foreign	$ 3,713,357	$ 1,337,750	$ 5,051,107	$ 114,826,075
Sales:	Domestic	330,107,508	60,886,048	390,993,556	1,031,750,623
	Total	333,820,865	62,223,798	396,044,663	1,146,576,698
Gross Payroll		37,103,113	14,002,892	51,106,005	196,137,511
Federal Tax (Including Deferrals)		7,077,525	1,032,976	8,110,501	34,070,601
State and Local Income and Property Taxes (Including Deferrals)		309,445	156,836	466,281	5,502,552
Research and Development		3,028,767	509,362	3,538,129	55,311,683
Pre-Tax Profits (Loss)		8,431,500	1,657,577	10,089,077	65,551,807
Total Assets		160,550,849	50,317,558	210,868,407	887,958,633
Long-Term Debt		58,242,680	12,274,276	70,516,956	172,859,014
Net Worth		$ 59,998,683	$ 8,727,657	$ 68,726,340	$ 410,726,911
Full-Time Employment - Year End		3,338	1,103	4,441	13,348
Number of Companies		46	6	52	52

* Excluding Leveraged Buyouts

** Leveraged Buyouts Only

Mr. ZICARELLI. Now I would like to tell you that every one of our investments over 21 years has been successful, but obviously that is not the case. Many have not been successful. In fact, back in the late sixties our SBIC had a serious capital impairment as a result of some poor investment performance up to that point in time, and we needed the cooperation and understanding of SBA to weather those difficult times. We were in default with them. Fortunately they cooperated with us. Some of the investments that we had at that time blossomed and we turned the corner, and we can proudly point to that fact, that the partnership has worked.

Let me discuss more about the industry than specific things about Northwest Growth Fund. We previously submitted to the committee several studies relating to the SBIC industry's impact on the economy in job creation and its cost effectiveness. In the interest of time I will not dwell on the details of those studies but, Mr. Chairman, I believe they prove beyond a shadow of a doubt that the SBIC program is not only an extremely cost effective method of channeling venture capital to promising young companies, but that it is also a uniquely targeted economic initiative. It helps small business, it creates jobs, it develops new technology, and generates additional tax revenue. These studies are clear evidence that the program is a proven success.

The CHAIRMAN. Your statement in its entirety will be included.

Mr. ZICARELLI. Yes.

The CHAIRMAN. I am just terribly afraid that I have about 10 minutes and I will have to go to the floor, and I want to make sure everybody has an opportunity to be heard before then.

Mr. ZICARELLI. All right. Let me just comment on some of the things that have been said earlier.

This is about the industry's overall regulatory record. Since the program's inception, NASBIC has worked very hard to achieve three basic objectives in the regulatory area: To eradicate all these major violations in the so-called big six; to reduce the technical violations; and to root out the few bad actors who may have slipped into the program. Unfortunately——

The CHAIRMAN. Just for the sake of time, I am asking questions as I go along. How do you find this 42 percent violation figure?

Mr. ZICARELLI. Mr. Chairman, I really find that quite hard to believe.

The CHAIRMAN. Well, we have gotten it straight from Small Business Administration itself.

Mr. ZICARELLI. One of the things about that statement that strikes me is that we have some 120 pages of regulations to abide by. There is a lot of detail in it, and it is easy for somebody to pick out some technical areas in which we have had defaults.

Our own bank holding company, which I mentioned earlier, has some 88 banks in it. I asked the head of our internal bank auditing operation just how their record stacks up against our industry, and he assured me that every one of our banks, when it is examined, is found to have some violations. I said, "Every one of them?" He said, "Yes. There is not an exception." They all have some violation of the Controller of the Currency's regulation.

Therefore, it seems to me that when we start to analyze numbers like that, maybe we are really distorting the concerns about this industry.

The **Chairman**. I do not think anybody is trying to distort. I am not, because I think just to listen to your roster of successful clients clearly indicates the proper purpose of the program, but we are still talking a substantial figure of violations, and we are not talking technical violations. Apparently we are talking about significant violations, and I am just wondering as to whether or not even further effort is required on the part of your association to reduce that figure, along with whatever the efforts of the Small Business Administration are.

Again, I have to repeat that I am a great believer in the SBIC and the MESBIC programs, but I want to make sure that at a time of budget cutting, that because of a few bad actors you are not used as the excuse for eliminating a very valuable program in the sense of capital and employment in this country.

Mr. **Burns**. Mr. Chairman, may I make a comment on that for the MESBIC industry?

The **Chairman**. Sure.

Mr. **Burns**. The first thing is, I think we feel that the violation citations referred to are those that are initially pointed out during the Inspector General's staff's examination and are not the violations that are finally outstanding. In our case, for instance, we get an audit letter—as everybody does—an audit letter each year with a claim of problem A, and invariably we will write back and say, "No; this isn't a problem for reasons X, Y, and Z." We will get a letter back saying, "Thank you very much. That clarifies that matter," yet in the audit report that first "Is this a problem?" would be reported as a violation.

The second thing is, I think it is important to stress—as is going on in NASBIC—AA MESBIC is aware of the need for regulatory compliance in all areas, is terribly concerned about acts of dishonesty as well as the procedural problems that may crop up from time to time, and has undertaken in conjunction with SBA a program to reinforce for our membership in various regions of the country an awareness of regulatory problems and the need to comply, in great detail. The first of these roundtable discussions was held in New York within the last 2 weeks. Additional sessions will be scheduled in other sections of the country, attended by all of the active MESBIC's in that particular region, in an effort to overcome even the smallest procedural problem. Therefore, there is an industry awareness of the need to comply and positive steps being taken.

Mr. **Zicarelli**. I do not mean to be defensive about our industry's performance, and we certainly do not condone the bad actors. They reflect on all of us and make it more difficult for each of us to do business.

However, for example, in Mr. Randolph's statement he stresses the fact that somebody overcharged interest if you presume that that loan was paid off in 1 year or 2 years. When the term of the loan is 5 years, you cannot presume that interest is exhorbitant if it is paid off before its term. It just seems to me there are a lot of issues such as that which people will claim a defense for, and I think that you run into that in trying to determine what First Capital was doing. They felt justified in their own minds as to what they were doing, whether they were or not, but I think the general——

The CHAIRMAN. If indeed First Capital was complying with the regulations, maybe we do not have enough regulations. I think obviously you fellows——

Mr. ZICARELLI. Well, obviously I am——

The CHAIRMAN. What I am saying is, I mean, if this can go on and people are not held accountable by anything that is on the books, then maybe we had better get something on the books that works because I think that is incredible.

Mr. ZICARELLI. I am certainly not using that as justification for what they did because I do not understand what they did.

The CHAIRMAN. Welcome to the club.

Mr. ZICARELLI. However, I am just saying that there are many citations made against us which we would have no defenses upon before they are entered into this record, and that is the distortion I see on these figures.

The CHAIRMAN. Mr. Jones?

STATEMENT OF E. PATRIC JONES, PRESIDENT, URBAN FUND OF ILLINOIS, CHICAGO, ILL.

Mr. JONES. For the sake of brevity, I will summarize my statement, very much so, Mr. Chairman.

I am with the Urban Fund in Chicago, Ill., owned by three banks. Since our inception in 1971, our investments have created about 3,200 jobs in the inner city, Chicago. Over the past—in 1981 the MESBIC industry as a whole invested $54.4 million in minority enterprises—over the past 5 years the total multiplier effect of our investments has created total capital investments of $600 million.

Among the issues that we have been working with the SBA on are the recently proposed changes in the SBIC MESBIC regulations. In the originally proposed form, many of the changes we felt would be extremely objectionable to the industry and would have a disastrous effect on the MESBIC program and their investees. We have been working with the SBA. The Investment Division in particular has been receptive to our ideas, and we are very optimistic about any potential changes in the proposed regulations. We are also very optimistic about our working relationship with the SBA.

One area that is of importance to us is the investment philosophy. I will summarize this very briefly. When the MESBIC program was created in 1969, its intended purpose was to provide assistance to minority-owned firms. In 1972, Congress mandated that the MESBIC's invest in businesses owned by socially or economically disadvantaged persons. We have come under fire, the MESBIC program, for providing assistance to minority entrepreneurs which some people consider of questionable eligibility. Congress established the definition of socially or economically disadvantaged. We feel that it is absolutely essential that we, the MESBIC's, have the flexibility to invest in individuals who have the potential to run businesses successfully. Any other attitude would doom the program and do a disservice to the minority business community.

In particular reference to this, a recent SBA legal opinion stated that Vietnam-era veterans are disadvantaged persons without regard to wealth, race, or ethnic background. I fail to see the investment logic in this policy when the MESBIC program is held to some means test of what is a qualified minority. We think it is time, perhaps, that Congress reevaluated that definition of the eligible participants in the program.

We are particularly concerned with the regulatory violations. The Inspector General's report that has been referred to repeatedly today, dated 1980, covered statistics for a 3-year period beginning July 1976. The report referred to the significant six violations. The report is based on information that today is 6 to 7 years old. The new figure that the Inspector General referred to today of 42 percent, we do not know what that statistic is based on but we would be very concerned if we are being held to task for data today that is 7 years old.

We question, further, the policy of the Inspector General in making recommendations that have far-reaching impact without making itself accessible to the industry to discuss the policies. In fact, during many of the SBIC audits the Inspector General has made recommendations on findings that are clearly not regulatory problems, yet when we invited them to our recent roundtable where the intent was to discuss ways of eliminating regulatory violations in the industry, the Inspector General declined to attend.

The next item of very much importance to us is the issue of idle funds. I will simply say that when the Inspector General measures the amount of idle funds and accuses a MESBIC of having too high a degree of idle funds, they fail to take into account that as an operating business the MESBIC is accumulating funds to cover its day-to-day operating costs, to retire debentures due the SBA, to pay dividends due the SBA, and to cover commitments that they have to small business concerns on which they have not disbursed yet. We feel that those are essential parts of a day-to-day operation and should be taken into account when defining idle funds.

The Inspector General also fails to take into account that there are many new MESBIC's with sizable infusions of new private capital that should be considered in evaluating further the issue of idle funds.

I would like to conclude by saying that the SBA is working with our industry to maintain the integrity of the program. We believe that the Investment Division's primary focus is the improvement of the industry, and we support that. We stress, though, that we think the SBA should be cautious in issuing regulatory policies that have a far-reaching, long-term negative impact on the industry.

Two instances: In 1981 they issued a 90-day licensing moratorium on SBIC's to allow the new administration to review the problems in the program. The intent was good. However, it resulted in a cessation of processing of new applications. In addition, the SBA instituted a policy of having the Small Business Administration regional officials do a preinterview licensing procedure of new applicants. The problem with that is that it caused an incredible delay in the processing of new applicants. One example would be a MESBIC wholly owned by International Paper Co. This new process forced this MESBIC to wait 1 full year to receive its MESBIC license.

We would like to commend the Inspector General for its efforts on behalf of the industry. We want to protect the credibility of the SBIC program also.

The **Chairman**. Thank you very much, Mr. Jones.

Mr. Burns?

STATEMENT OF PATRICK OWEN BURNS, PRESIDENT, MINORITY EQUITY CAPITAL CO., INC., NEW YORK, N.Y.

Mr. **Burns**. I would like to make one or two what I hope will be positive comments to close out these hearings, in light of some of the earlier negatives that we have heard. As my basic text I would refer you and the committee to the U.S. General Accounting Office's report of August 1982 on the venture capital industry, where it states: "The venture capital process, when working successfully, can improve the Nation's economy and enhance its productive growth." It goes on further to emphasize:

> Because of the important potential benefits that can be obtained from available venture capital, both the Government and the industry have a stake in seeing that the process works successfully. Coincidentally, actions by either or both can influence whether complex and sophisticated venture capital processes will work successfully.

I think the discussion of the regulatory process and the Inspector General's oversight activities of both the MESBIC and SBIC industry unfortunately ofttimes ignores the fluid process of venture investing—and I am not talking about what we have seen, but about the complexity of some of the decision processes and financing arrangements that are necessary in support of legitimate small business investments. We feel, in the MESBIC segment of the SBIC industry, that there are a number of positive benefits of the SBIC industry that perhaps are too often ignored. One is the private sector leadership in seeking investment opportunities and making capital available to growing small businesses.

This capital, particularly in our industry, is capital that would not otherwise be available for minority businesses, frequently because of their size and relatively limited upside potential. The program itself provides a method for a large number of major corporations—to participate in the investment process, a process that they would not undertake on their own in financing small minority businesses. However, they are induced into the MESBIC program because of the leverage benefits, and frequently join in consortium MESBIC's to provide capital to potentially growing and strong minority-owned businesses.

The availability of capital for these minority businesses across the country results in two benefits, or a variety of benefits, actually. One is clearly defined. In deed, we have already heard some comments on the economic benefits, job creation, tax payments, opportunities for capital accumulation, and so forth. One of the things, however, we do not focus on, although it was cited earlier this morning, is the human capital that is created. We in our portfolio have companies where the presidents of the companies having started ventures years ago with minor portions of capital, have through perseverence and the assistance of the SBIC industry and

MESBIC industry been able to create substantial ventures, and have then started to participate in the broader economic and business life of the minority community.

The publisher of Essence magazine, for instance, who now serves on the board of Spelman College in Atlanta and is vice chairman of Freedom National Bank in New York City, built on the success of a startup venture that went through the tortures of the damned for 6 or 7 years but, which aided by the perseverence of capital provided by MESBIC's and in a couple of instances SBIC's, has turned into a very profitable and important—both symbolic and economic—venture in the minority community.

Several of the important cable companies, for example, one in Columbus, Ohio, a cable franchise being developed in Newark, cable franchises being developed in New York and a variety of radio broadcast companies across the country which have had MESBIC financing have permitted leadership opportunity as well as economic benefits to accrue to the minority communities across the country. I think these kinds of benefits of the program sometimes get overlooked, as do the straightforward economic benefits. There are problems, but we think that with everybody working together they can be solved and that the program can be strengthened for the benefit of all.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Jones, Mr. Burns, Mr. Zicarelli, and Mr. Stults.

The committee will stand adjourned.

[Whereupon, at 1 p.m., the committee recessed, to reconvene at the call of the Chair.]

[The prepared statements of Mr. Zicarelli, Mr. Jones, and Mr. Burns follow:]

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STATEMENT OF

ROBERT F. ZICARELLI

Before the

SENATE SMALL BUSINESS COMMITTEE

December 16, 1982

MR. CHAIRMAN AND MEMBERS OF THE COMMITEE:

I am Bob Zicarelli Chairman of Northwest Growth Fund and I am also serving this year as Chairman of the National Association of Small Business Investment Companies (NASBIC), the trade association which represents most licensed small business investment companies (SBICs) and minority enterprise small business investment companies (MESBICs).

We deeply appreciate this opportunity to discuss our program with you. We're proud of our industry, and of the job we are doing to help the nation's growth-oriented small businesses. On the other hand, we realize that every program -- including ours -- has its problems, and we are grateful to the Committee for taking this time to constructively examine the SBIC industry. I think we all agree that small growth companies will play a vital role in our economic recovery, and that a healthy venture capital community is essential to help them achieve their potential. To the extent that we can work together to improve and expand the SBIC program and maintain high standards of operation within the industry, the country will benefit from the economic stimulation that will result.

As you know, Congress created the SBIC program in 1958, when it passed the Small Business Investment Act. Today there is great diversity within the industry, but several general comments can be applied to all SBICs. SBICs are created for the purpose of providing equity capital, long-term loans, and management assistance to new and growing small business concerns. SBICs are privately-organized and privately-managed. In addition, all SBICs are licensed and regulated by the Small Business Administration.

NORTHWEST GROWTH FUND

Let me briefly discuss the SBIC I know best - Northwest Growth Fund. Our SBIC was licensed in 1961, so we've been in this exciting business of providing venture capital to small, emerging growth companies for some 21 years. Northwest was originally organized by Northwest

Bank Corporation, a bank-holding company, and a dozen individuals. Northwest Growth Fund has been a wholly-owned subsidiary of the bank-holding company since 1979. Our SBIC has private capital of $10 million, of which approximately $3 million is paid-in capital and $7 million is retained earnings which have been capitalized. In addition we have nearly $30 million in realized and unrealized retained earnings, and SBA leverage of almost $23 million. Our total assets are approximately $37 million at cost and over $75 million at market value. While our company is headquartered in Minneapolis, we also have branch offices in Denver, Colorado and Portland, Oregon.

NORTHWEST GROWTH FUND'S PORTFOLIO

I am quite proud of Northwest Growth Fund's 21-year record. During this time we have invested $65 million in, and provided substantial management counsel to, 150 small firms. Our current portfolio consists of 70 businesses in which we have a total outstanding investment of $36 million at cost. Our portfolio is somewhat unique because of its diversification. For example, while a substantial number of our investments have been in Minnesota, our branch office system has provided us the opportunity to diversify geographically; so that we now have investments in 16 states. Northwest Growth Fund's portfolio also reflects our management philosophy of trying to design financings to meet the needs of each small business on an individualized basis. As a result, we have provided a wide variety of types of financings to small firms, ranging from common stock to second mortgages. Finally, our portfolio is characterized by a wide diversity in the types of firms in which we have made investments. Included in our portfolio are some very high-tech businesses such as Cray Research, which is the builder of the world's largest scientific computers, and Molecular Genetics, a genetic engineering firm which recently received publicity for a herpes vaccine it has identified. Some other more mundane companies are also in our portfolio, such as the Vee Corporation, which produces a road-show version of "Sesame Street," and Minnetonka, the makers of soft soap.

LOCAL ECONOMIC IMPACT

Because we believe strongly in the contribution of SBICs to the areas we serve, Northwest Growth Fund has done its own economic impact analysis. We think the results are extremely gratifying and form a record that the Government and our SBIC can look to with pride. I have submitted for the record the findings of that analysis. It shows rather spectacular gains in most areas of economic measure for the 52 companies in our portfolio as of December 31, 1981. These firms have had sales increases of over 300 percent, including export sales which have gone up nearly 23 times. Pre-tax profits of these companies are up 550 percent since we made our original investments. We have shown employment gains in these 52 companies of nearly 9,000 new jobs since our original investments and taxes paid in the most recent year total nearly $68 million, compared to less than $20 million paid by these companies before our investment.

We think those results represent a significant contribution to the economy by those portfolio companies.

NORTHWEST GROWTH FUND'S PERFORMANCE RECORD

I would like to tell you that every one of our investments over 21 years in the business has been a winner, but obviously, several have not been successful. In fact, at one point in time 15 years ago, our SBIC had a capital impairment and we needed the cooperation and understanding of our SBA partner to weather those difficult times.

To SBA's credit, they were patient; we turned the corner and the partnership has worked. The major beneficiaries have been a large number of small firms that have prospered and expanded in terms of sales, profits, jobs and net worth.

Northwest Growth Fund's experience has been equally gratifying. We have had a compounded annual growth rate of more than 20% over the 21-year life of our company. In achieving these results we have made good use of SBA leverage, now at a ratio of slightly more than 2 to 1 to our paid-in capital. The SBIC program is based on free-market, profit-motivated principles, and I have no hesitation in telling you that's why our parent bank-holding company is involved. They're in business for profit and they have realized a substantial return on their investment. Since our acquisition by Banco in 1979, the holding company has earned more than $15 million before taxes and Northwest Growth Fund has distributed over $4 million (at market value) of investments to its parent, whose direct investment in NWGF was less than $2 million, and whose cost to buy out minority shareholders totaled $8.5 million.

THE INDUSTRY'S RECORD

But rather than dwell on Northwest Growth Fund itself, I'd like to talk about the industry for a moment. Over the past 23 years, SBICs have invested more than $4 billion of equity capital and long-term venture loans in over 60,000 small business concerns. Today, over 360 SBICs, with assets of more than $2 billion, are actively engaged in the financing of emerging growth companies. In calendar 1981, SBICs invested a record total of $333 million. From January to June of this year a six-month high of $175 million was invested in small concerns by SBICs. It is interesting to note that increasing amounts of SBIC financings are taking the form of straight equity or equity with debt characteristics - three-fourths of the investments in the first six months of 1982 were in this category.

These financing statistics and the increased number of large, new SBICs coming into the program are clear indications that in spite of uncertain economic conditions, hundreds of venture capitalists and entrepreneurs are willing to risk their money and reputations on the ability of innovative, well-managed small firms to grow and be profitable.

ECONOMIC IMPACT OF SBIC ACTIVITY

Two years ago, in an effort to determine the impact of SBIC financing on small businesses, NASBIC commissioned the international accounting firm of Deloitte, Haskins & Sells and the economic consulting firm of Arthur D. Little, Inc. to do a data base survey of SBIC portfolio companies. The survey, completed in early 1980, showed that SBIC-financed small firms experience growth rates almost 10 times as great as those of other small companies in such key areas as sales, profits, and employment. The study also showed that the growth of Federal tax payments of SBIC portfolio companies is over 5 times that of all other small concerns.

Incidentally, these figures are compatible with those derived from a study conducted independently by the Investment Division of the Small Business Administration.

ATTITUDE OF SBIC PORTFOLIO COMPANIES

The figures from the economic impact studies are impressive; however, the results would be less important if the small concerns that the SBIC program was designed to promote did not value SBIC assistance. SBA's own surveys over a period of six years fully demonstrated that SBIC portfolio companies place a high level of value on SBIC assistance. The portfolio companies in SBA's surveys were selected on a statistically random sample basis and responses were given anonymously in order to assure the replies were credible and unbiased. Over 95% of the entrepreneurs questioned said the SBIC investment was of significant importance to their firm's growth, and 90% gave clear evidence of their satisfaction with the SBIC relationship.

COSTS/BENEFITS OF SBIC PROGRAM

Deloitte, Haskins & Sells followed up their economic impact survey with a second study, designed to measure the direct cost to the Federal government of the SBIC program, and the benefits generated by SBIC activity. DH&S found that in 1979, Uncle Sam spent only $4 million dollars to run the SBIC program -- $2 million on administrative costs and $2 million to cover losses on loans to SBICs. In return for that $4 million, the Federal Government received a total of $440 million in increased tax payments from SBICs, their portfolio companies, and the employees of those portfolio companies -- a cost/benefit ratio of 1 to 110. I have been unable to find any other government program that comes even close to generating such tremendous benefits at virtually no cost to the tax-payer.

JOB CREATION THROUGH THE SBIC PROGRAM

A third impact area of SBIC financing that is important to examine is that of job creation. David Birch of MIT found, in his landmark study of the job creation process, that two-thirds of all the net new jobs were created by firms with 20 or fewer employees and 80% of these jobs were in companies four years old or younger.

These are the companies in which SBICs invest. The 1981 SBIC Annual Financing Survey from the SBA indicates that 66% of the financings and 67% of the dollars disbursed by SBICs went into firms 4 years old or younger. 64% of the new 1981 portfolio companies had fewer than 20 employees. I mentioned earlier that the DH&S/ADL economic impact study showed that SBIC-backed companies generated 10 times the employment growth of other small businesses.

The Deloitte, Haskins & Sells study also reached another striking conclusion - that the actual cost to the government of creating a job through the SBIC program is only $312. This is a remarkable result unmatched by any other Federal program.

Mr. Chairman, I believe these studies prove beyond the shadow of a doubt that the SBIC program is not only an extremely cost-effective method of channeling venture capital to promising young companies, but that it is also a uniquely targeted economic initiative. It helps small business, creates jobs, develops new technologies and generates additional tax revenues.

THE ORIGINAL CONGRESSIONAL OBJECTIVES

When Congress passed the Small Business Investment Act of 1958 it was a risky experimental program -- an unusual government-private sector partnership designed to address a public policy issue -- the small business equity capital "gap." Congress settled on SBICs as private, for-profit businesses after rejecting the idea of a straight Government agency or quasi-public corporation (such as RFC) to do the job.

When Congress passed and President Eisenhower signed the Act in 1958, four basic questions were still unanswered.

1. Would private investors and managers put their dollars and talents to work in this enterprise?
2. If so, could SBICs overcome all the odds shown in business survival data and make money in this high-risk program?
3. Would entrepreneurs and small business owners be willing to accept outside investors or partners in their closely-held firms?
4. How much money would Uncle Sam lose by making loans to these SBICs?

Twenty-three years later, we have the answers to all those questions. The SBIC program has attracted over $1 billion in private capital and hundreds of highly-talented managers. The SBIC industry overall has become profitable and many SBICs have made a highly attractive return on their private capital. Hundreds of thousands of small businesses and would-be entrepreneurs have applied for

SBIC dollars and SBA surveys have shown that 95% of all those receiving SBIC assistance have been delighted they did so. And finally, the Federal Government has lost only a tiny number of dollars from defaults on loans to SBICs; at the same time, it has received many times as much from direct tax payments of SBICs alone, as well as additional revenues from increased taxes paid by portfolio companies and their employees.

For all these reasons, we feel the SBIC program is a proven success on every count.

WHY IT'S BEEN A GREAT SUCCESS?

Why has the SBIC program been the finest model of private/public partnership in government? The answer is simple -- the program capitalizes on a blend of principles which have been tested over time and proven to work. The first element is the profit motive, the driving force behind America's free enterprise system. This is combined with the concept of private capital at risk, creating a risk/reward relationship which forces the program to meet the test of bottom-line realities through privately negotiated transactions. Because an SBIC's success is totally dependent on the success of its portfolio concerns, a market discipline is built into the system which causes the SBIC to deal fairly and equitably with small firms in its portfolio and simultaneously shields the government's exposure to risk. Added to this is the feature of privately managed SBICs, allowing the industry to compete for and provide the best available talent. The final element involves a degree of balanced but limited government intervention, giving the SBA an ability to concentrate on program oversight with a minimal drain on scarce Federal resources.

Blending these elements into an effective, working program requires a true partnership between the SBIC industry and the SBA.

THE PARTNERSHIP - SBA's OBLIGATION

The SBA also has an obligation to this partnership. In order for the SBIC industry to effectively perform its critical venture financing role, its Federal partner must provide a positive governmental environment which is conducive to SBICs operating in accordance with commonly accepted business principles. As a recent General Accounting Office (GAO) Report on the venture capital industry concluded:

> "The venture capital process is very sensitive to Government policies, rules and regulations. Industry and Government should work together to identify pertinent issues

and suggest actions needed by either or both sides to create the greatest likelihood of a successful venture capital process in an environment of increasing capital supply.*

In order to create and sustain this positive environment it is essential that SBA provide: (1) continuity in program policy over the long term; (2) a shared acceptance of financial risk as a partner in the SBIC process; and (3) a reasonable and balanced approach to regulatory oversight of SBIC operations. These three building blocks provide the foundation for the program, and the fact that they were effectively in place for a number of years gave the industry its opportunity to achieve the phenomenal record of success referred to earlier.

POLICY CONTINUITY

SBA must recognize that the venture capital business is a long-term business. The venture capitalist is far more than a financial intermediary supplying capital to an entrepreneur. Venture capitalists seek out new markets and new technologies, entrepreneurial talents, and management resources and combine them into business opportunities that have significant growth potential. Faced with hundreds of judgemental decisions which can translate into millions of dollars gained or lost for their investors, it is essential that SBIC managers be able to rely with some degree of certainty on long-term continuity in Governmental policies. If that certainty disappears and SBA becomes an unreliable partner, it will simply destroy the program.

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* "Government-Industry Cooperation Can Enhance The Venture Capital Process," a report by the General Accounting Office to the Joint Economic Committee of the Congress, August 12, 1982.

SBA - A PARTNER AT RISK

Access to long-term leverage at reasonable cost is the single most important governmental incentive to the SBIC industry. Any vacillation by SBA on leverage policies which erode this partnership role would be a highly destructive course of action. It would have a demoralizing effect on the industry and ultimately would impose great harm on small growth companies in need of venture capital.

BALANCED REGULATIONS

The third element which is fundamental to an effective SBA-SBIC partnership is a regulatory atmosphere which is fair and reasonable and recognizes both the realities of the venture capital process and the benefits that the private marketplace provides. Freely negotiated transactions which involve complex value judgments and risk/reward decisions are the creative force in the SBIC investment process. Any arbitrary Government intervention in these free market negotiations, or regulatory formulations which build biases in favor of one type of transaction over another, or regulatory rigidity which precludes negotiating flexibility is antithetical to and destructive of the process itself.

It seems to me that SEC Commissioner Barbara Thomas, was right on point when, on July 7, 1981, she said:

> "Taking substantial, calculated risks to accomplish worthwhile goals has been the unique genius of the American people -- encouragement of new capital formation requires a shift away from the official discouragement of risk taking which has resulted from much of the government regulation in recent years. Although government must protect the many from the fraudulent devices of a corrupt few, it must take care not to destroy the ingenuity and entrepreneurial spirit which it initially sought to encourage. Government cannot

> protect entrepreneurs from their own folly; government cannot shield investors from loss. Risk is inherent in economic activity. We cannot sterilize risk from our economy without killing the economy."

Unfortunately, the major elements of the original version of Revision 6 violated these basic principles. To the Agency's credit, after a virtual onslaught of lengthy, well-reasoned objections by the SBIC industry, SBA has advised us they are withdrawing several of the most objectionable features of proposed Revision 6. They have also indicated that a number of remaining areas where there is strong industry objection are "open for discussion," and they have invited industry representatives to meet with them on these remaining issues. Those discussions are now underway.

THE PARTNERSHIP - THE INDUSTRY'S OBLIGATION

The industry's obligation to the partnership involves, and SBA has every right to expect, a good faith commitment to play by the rules. We believe the industry's record in meeting this obligation has been positive. NASBIC has continuously worked for a "zero-defect" industry, has pressed for initiatives which would remove those who flagrantly and willfully violate SBA's regulations, and has cooperated with the Government in its attempts to weed out such miscreants.

NASBIC continues to spend a major share of its resources on positive efforts to minimize all types of regulatory violations.

In each year since 1975, NASBIC has conducted a week-long Management Institute. One of the chief reasons for this educational program is our desire to acquaint SBIC professionals with the regulatory requirements of the program. In September of this year we had another capacity attendance of 100 SBIC executives at the 1982 Management Institute, and once again heavy emphasis was placed on compliance with SBA regulations.

NASBIC has covered SBA regulations at every one of its 24 Annual Meetings. Top level officials from SBA and our officers and staff have stressed the importance of understanding and complying with the regulations. These sessions have always been given great prominence and have been well attended. Just six weeks ago SBA Administrator Jim Sanders and several top level officials from SBA's Investment Division spent many hours at our Annual Meeting in detailed discussions of SBA regulations with our members.

In addition, our National membership is divided among six Regional Associations and these area groups hold annual meetings, as well as periodic workshops. At least once a year, NASBIC and SBA staff utilize these Regional platforms to explain recent changes in the regulations.

Finally, NASBIC occasionally undertakes a major initiative in the regulatory area. In 1979, a blue ribbon panel of Association officers spent many days in the field and in Washington exploring every facet of the current regulations and drafting a series of 50 recommendations for clarifying, streamlining, and strengthening SBA's rules for SBICs. We submitted our Report to the Administrator of SBA on March 31, 1980. Our major goal in undertaking that project was to minimize the number of violations, both through clarifying complex regulations and through eliminating those which served no useful purpose.

CRIMINALS AND SHARP OPERATORS

This brings me to the SBIC industry's overall regulatory record.

As I mentioned, since the program's inception NASBIC has worked very hard to achieve three basic objectives in the regulatory area:

1. To completely eradicate all "major" violations,
2. To reduce "technical" violations to an absolute minimum, and
3. To root out the few bad actors who may have slipped into the program.

Unfortunately, and despite our best efforts, we - and I mean both the industry and SBA - have not been fully successful in keeping the bad apples out of the barrel.

As much as it pains me, I will be the first to openly recognize that over the years a small number of out-and-out criminals, embezzlers or sleazy operators have been involved in the SBIC program. You can rest assured that the SBIC industry and its leadership finds these characters even more reprehensible than does the Inspector General or the Investment Division.

We know that the vast majority of SBIC managers are honest and reputable businessmen who are attempting to make a fair profit through legitimate business practices in a complex, fast-moving, high-risk field. We know they have a sincere respect for both the spirit and the letter of the law and regulations which govern their operations.

The few crooks who gain entry to the program do a grave disservice to our industry, and their actions tarnish our good character as well as the industry's image. We are more interested than anyone in getting these bad actors out of our business and keeping them out.

Unfortunately, no law however tough and no regulation however strict can completely eliminate those with larceny in their hearts. Fortunately, the SBA regulatory and audit system does work; and those selective few who would violate the law are eventually caught and dealt with through the proper course of due process.

INNUENDO AND NUMBERS GAMES

Having made that painful admission, I would also like to get two other items off my chest.

Those of us who run SBICs in conformity with the spirit and letter of the law and regulations - and that's the overwhelming majority of SBICs - deeply resent the practice of using innuendo to transform the abusive activities of a small number of violators into grossly misleading and unfair allegations which discredit the total SBIC industry. The Inspector General's Report of February, 1980 used this ploy to suggest that all SBIC managers violated the regulations "with relative impunity." Nothing could be further from the truth. Likewise, the Wall Street Journal article of June 8, 1982 was simply an exercise in sensationalist journalism totally out of character with that paper's fine reputation.

We are also irritated by the superficial use of numbers to exaggerate and distort regulatory violations, when no attempt is made to deal with the underlying substance and subtleties behind those numbers. The Inspector General's Report employed this technique in presenting aggregate numbers in a misleading manner which exaggerated the severity of non-compliance with SBIC regulations. I'd like to make two points here. First, the investment business is a complex transactional business. The development and negotiation of venture capital transactions does not fit neatly into a complex regulatory framework, and absolute conformity requires an enormous effort at due diligence. So technical violations do not shock or surprise me, particularly when SBIC audit reports are compared with examination reports of commercial banks. Where "major" violations are alleged it is essential to look at the substance of each transaction to determine if a truly serious violation did, in fact, occur to the detriment of a small business or the government. The second point is simply that SBA should improve and refine its system for defining and reporting actual, serious SBIC violations, if only to put an end to any further allegation of "numbers games."

Reporting gross number of "alleged" violations may make good headlines, but they simply distort the real picture of how many serious violations actually take place. We are aware of several instances in which an SBIC was "alleged" to have committed 40, 50 or even 90 major violations, and these were added on to the gross numbers scorecard, only to find later that not a single real violation took place. Moreover, the so-called "Big Six" major violation categories -- which are supposed to define those infractions seriously detrimental to small firms or the SBA -- is actually a misleading classification, since many of the violations captured in this net are merely technical in nature or de-minimus in impact.

In fact, we contend that the industry has a good record when it comes to serious, "major" violations. SBA's own analysis shows that when alleged violations which turned out to be non-violations, multiple-countings of the same transactions, de-minimus and merely technical violations are netted out of the gross numbers:

1. 80% of all SBICs have no "major" violations,
2. The rate of actual "major" violations per SBIC is quite small (0.4 per SBIC), and
3. Truly serious violations which are in fact detrimental to small business or to the SBA as a creditor are concentrated in a very small number of SBICs. We estimate this to be no more than 5% of the industry.

We're as interested as anyone in determining the real magnitude of truly serious violations and in supporting actions to eliminate them. We would be pleased to work with the Investment Division and the Inspector General's office to accomplish this.

THE INSPECTOR GENERAL'S REPORT

My comments should not be construed to diminish the importance of the Inspector General's Report or to suggest that serious violations have not occurred. As I stated previously, we have had instances of abuse in the program - some flagrant. Moreover, the Inspector General's Report of February, 1980 did contain a number of very positive recommendations to improve the SBA's regulatory oversight of the program. We understand a substantial number of these recommendations have been implemented.

The Report contained 15 recommendations in five different categories. Several of the recommendations relate to SBA's management of the program. It would be inappropriate for us to comment on those dealing with SBA's internal organization and administrative operations, so I will confine my remarks to those items relating to program policies and practices.

One series of recommendations deals with a type of abusive practice referred to as "capital manipulation." These are cases of out-and-out fraud where an SBIC misrepresents the amount of its unrestricted and unencumbered private capital in order to secure "leveraged" public funds from SBA. Clearly, this kind of criminal activity is abhorrent to the industry and should be stamped out. The Inspector General recommended a series of steps which would enable SBA to ensure that the level of private capital being represented did actually exist and was unencumbered and unrestricted. These were:

1. Improved bank confirmation procedures,

2. Improved documentation from all principal stockholders of the SBIC as to the source and status of their capital investment,
3. A more precise definition of what "commitments" meet the qualification test for first tier leverage, and
4. Elimination of the practice of making first tier leverage automatically available to MESBICs without meeting a "needs" test.

None of these actions will eliminate the intentional perpetration of fraud. NASBIC supported these actions as a constructive set of steps which make it more difficult to get away with a false representation of private capital. It's our understanding that the majority of the fradulent capital schemes were used to secure automatic first tier leverage available to MESBICs. Elimination of this incentive should substantially reduce or eliminate abuses in this area. We're pleased that the Investment Division and the Inspector General have agreed on these points, and we understand they have all been implemented.

Another section of the Inspector General's Report deals with the range of regulatory sanctions available to and employed by the SBA. The IG takes the Investment Division to task for failure to use all of its sanctions powers and for what the IG describes as excessive indulgence in no more than "protracted letter writing." The IG recommends:

1. A review to determine how a broader range of sanctions can be more effectively used,
2. A more judicious use of examination letters as only one of several types of sanctions,
3. Several steps to improve communications with the industry relating to regulations and their enforcement.

Several comments seem appropriate. First, as I indicated previously, we feel very strongly that in those cases where there has been flagrant, willful or repeated abuse of the regulations, SBA should take strong corrective actions -- to the extreme of revoking the SBIC license if that's warranted. On the other hand, this business does involve complex transactions which may appear to an SBA auditor to be a violation, but are found not to be after all the facts are reviewed in detail. Elementary rules of due process would suggest that SBIC managers should be given an opportunity to respond to allegations of regulatory wrongdoing before they are labeled as incorrigible sinners.

While we are not privy to all the enforcement actions taken by SBA, we do have a clear impression that the examination letter is a useful and effective regulatory tool which provides notice, elicits information and has achieved a reasonable degree of corrective action. In addition, we are generally aware that the Investment Division has consistently used other sanctions to achieve compliance, including license suspension or revocation; acceleration of debt and transfers to liquidation; denials of requests for funding or regulatory approval; probationary status; referrals for investigation and criminal action by the Justice Department. It's difficult for us to assess whether additional enforcement tools or additional flexibility in their use are necessary, but we would be pleased to work with SBA in this area.

We also stand ready to work with the Agency in any way we can to improve communications with the industry on regulatory matters. I've previously mentioned the extensive efforts we've made in education and communications. Regulatory compliance is an area in which NASBIC, the Investment Division and the Inspector General all have a mutual objective - zero defects - although our motiviations may differ slightly.

Another set of recommendations relate to the audit function performed by the Inspector General's office. One suggested change would require that an SBIC be audited once every two years. While this represents a change from the current legislative requirement that an SBIC be audited every year, its intent is to make the regulatory audit process more effective. The IG feels that shifting to a two year mandatory cycle would provide the latitude necessary to concentrate his auditing resources on new companies and "problem" SBICs which had records of recurring regulatory problems, while auditing those SBICs with clean records only once every two years. We note the Chairman has included it in S. 2408.

On this same point, NASBIC has also recommended to the Inspector General that he consider implementing a new auditing practice which would involve several categories of audits depending on the track record of the SBIC involved. Under such a procedure, every SBIC would be subject to the basic requirement of meeting certain minimum regulatory standards. This "review" audit would apply to those SBICs with established track records of sound regulatory performance. A second category of SBICs, those with a history of minor violations, would be subject to a slightly more thorough confirmation audit. Those SBICs with a mixed record would be subject to an even more intense review. New SBICs and those with problematical records would get a full-blown audit. An approach of this nature has been adopted by the CPA industry. We believe it would be more efficient and economical, and makes good business sense in terms of the IG's deployment of a limited auditing staff.

The Inspector General's report makes another recommendation in the auditing area which gives us great concern. The IG proposes that as a condition of receiving financing from an SBIC, every portfolio company must authorize the Inspector General to review its books and records.

In the report the IG recognized that many people would view this as "significant overreaching by the Government." He was unmistakably correct - it would be perceived by some as exactly that. It also appears to represent an extreme overreaction to one isolated case of collusive fraud, which more than likely would not have been detected even if this recommended authority had been in place.

The recommendation causes us concern for several reasons. First, the IG makes no real case for its necessity. With the exception of the one isolated instance there is no evidence presented that the existing system of voluntary access to portfolio company books and records, supplemented by the use of available subpoena power, is not satisfactory. We believe most SBICs recommend that their portfolio companies make their books and records available to SBA auditors for routine, random-sample audits. But the decision to do so is strictly up to the portfolio company.

We also have serious concerns because of "due process" and invasion of privacy considerations. Although we have no reason to question the IG's stated intent to use the police power "judiciously" and only in "discrete cases," the purported remedy could be much worse than the problem. In practice, good intentions are often lost or forgotten in the Government's exercise of police powers.

The issue here is not whether the IG should have access to the books and records of the SBIC portfolio concerns in appropriate cases. We agree that the IG already has that power under Section 6(a)(4) of the Inspector General Act of 1978. The real issue is how the IG can exercise his authority in a manner which least disrupts the activities of the SBICs and their portfolio concerns while protecting the legitimate interests of SBA. We believe the issue is of such significance that any broadening of the IG's powers should be accomplished through the legislative process, not by regulation, so that proper consideration can be given to all of the constitutional, due process and privacy issues which are involved.

IDLE FUNDS

In October 1981, SBA's Office of Inspector General issued a Management Advisory Report (MAR) focusing on the subject of "idle funds" held by SBICs and MESBICs. Even though the Introduction to this report specifically stated that "No MAR is intended to be the last word on a particular topic", this one was widely circulated and has often been cited as proof that the SBIC industry is not using the leverage it receives to help small business.

We reject that allegation. The IG's Report on idle funds is statistically misleading and its conclusions reveal a complete lack of understanding of the operations of the SBIC industry. Furthermore, the passage of only one year has proven that the basic premise of the report was absolutely false.

Stated most simply, the Inspector General concluded that SBICs drew down leverage from SBA at a relatively low rate of interest and made profits merely by placing those uninvested dollars in CDs or Treasuries which paid a much higher return. We all know what has happened in these past few months: the yield curve has reverted to its normal pattern and our long-term leverage costs much more than we receive on short-term investments. As a matter of fact, it has never been possible for a 301(c) SBIC to obtain a reasonable rate of return through investment of leverage in short-term securities.

It is possible that a few SBICs and MESBICs have been inactive and have not invested their dollars over an extended length of time. To indict the entire industry on the basis of a relatively few cases, however, is not fair. Furthermore, I know that the Investment Division has cited such licensees for inactivity and has refused either to provide further leverage or to roll over maturing leverage.

Let me cite the case of my own SBIC, Northwest Growth Fund, as a more typical situation. On December 31, 1980, our balance sheet showed cash and equivalents totaling a bit more than $6-million. Since our private capital then was about $7-million, a static analysis like that made by the Inspector General would have you believe that $6-million (an amount almost equal to our private capital) was "idle". BUT, in calendar 1981, we invested a total of $14-million which not only used all that $6-million, but also utilized the additional $8-million we borrowed from SBA during 1981. I caution you, then, against drawing conclusions from a simplistic addition of a column of numbers.

The IG's Report lumped 301(c) and 301(d) licensees together, even though their leverage costs differ fundamentally. Furthermore, the Report completely ignored the fact that a top level policy decision reached in the early 1970s directed the Investment Division to provide immediate "first-tier" leveraging to new 301(d) licensees as a partial offset to the additional management costs borne by such SBICs. SBA's policy was well publicized and approved by Congress, so it is strange that the Inspector

General castigated the Investment Division for permitting the idle funds of MESBICs to equal 100% of their private capital. Incidentally, SBA changed its MESBIC leverage policy last year, so any future analysis of idle funds in that segment of the industry will find a different picture.

I have reviewed the statistics in the IG Report quite carefully and must question the methodology, even though I do not have access to the underlying financial reports. First of all, I am troubled by the extrapolation made so glibly on the first page. The IG looked at the annual reports submitted by 345 reporting 301(c) and 301(d) licensees which showed a total of $321-million in uninvested funds; he then stated that 500 licenses were outstanding, so they were assumed to hold a total of $500-million in idle funds. The IG makes no effort to show that the non-reporting SBICs averaged more than $1-million each in idle funds. I guess a half-billion dollars sounded like a nice round figure.

Much more important, however, was the fact that the Report made no effort to break down this assumed industry-wide total into meaningful categories. For example, I have already mentioned that MESBICs, by policy direction, were expected to hold at least 100% of their private capital in idle funds. In addition, over 40 SBICs and 25 MESBICs were licensed in the year preceding the reporting date used by the IG; these licensees brought $65-million in inital private capital into the industry. It would be unrealistic to expect all of those dollars to have been invested quickly. I come next to a third factor which should have been mentioned: during fiscal 1980, the reporting 301(c) SBICs sold securities worth over $125-million, so these dollars, too, added to the pool of dollars available for investment.

A further observation: SBA's own report for fiscal 1980 shows that the 301(c) SBICs reported a net increase of only $53-million in SBA leverage during the year. That compares with the more than $280-million invested by 301(c) SBICs during the same 12-month period. That fact alone (and it comes from SBA's own tabulation) should have been sufficient to persuade the IG that the hue and cry over "excess idle funds" was a non-issue.

I cannot conclude this portion of my testimony without pointing out that no SBIC can be certain whether or not it will be able to roll over its maturing leverage, let alone acquire new Government loans for investment. If we could be certain that SBA would renew our maturing debentures (and at a reasonable interest rate) and if we could be certain that SBA would extend additional leverage to us on a timely basis when we require it, then a prudent SBIC executive might decide to reduce his pool of idle funds. As one who has been in the SBIC business for over

20 years, however, I can tell this Committee that SBA has been able to extend such an assurance on very few occasions. Several SBICs have recently learned to their sorrow that SBA either cannot or will not approve the rollover of maturing leverage or the extension of new loans. Those examples have convinced me, and most other SBIC executives, that we better conservatively manage our uninvested dollars, not only to meet the needs of small businesses already in our portfolio, but also to remain solvent in case SBA is unable to approve our request for leverage.

Incidentally, the liquidity squeeze I mention is not the fault of SBA alone. The Office of Management and Budget and the Congress recommend and act on the maximum dollar level of loans available for the SBIC program. If SBA does not receive sufficient authorization, it must ration a limited supply as fairly as possible. We recognize that, and we must proceed accordingly.

WALL STREET JOURNAL ARTICLE

This inevitably brings me to another "report" on the SBIC program -- one that appeared in the Wall Street Journal on June 8, 1982. A Journal staff reporter -- under the provocative heading "Small Business Loans Aid 'Minority' Whites, The Rich, a Porn Firm" -- presented the

SBIC program in a style calculated to outrage any conscientious taxpayer.

I must confess that I would like to dismiss this article outright as an exercise in slanted, sensationalist journalism unworthy of serious consideration, because I sincerely believe that no effort whatsoever was made to present a true picture of the industry. However, I'm fully aware that impressions created by the press -- particularly bad impressions -- tend to remain embedded stubbornly in the minds of readers. I would rather confront this particular article head on than to have you, Mr. Chairman and Members of the Committee, feel any lingering doubts about the integrity of the SBIC program and the individuals involved in it.

As I said earlier, NASBIC categorically condemns all willful and flagrant violations of the SBIC regulations. Although we realize that in an industry as active and diverse as ours, some violations are inevitable, I think I have demonstrated that our compliance record is very strong. Unfortunately, of the 60,000 small firms that have received SBIC financing, and the more than 10,000 companies currently in SBIC portfolios, the Wall Street Journal focused exclusively on a handful of investments with extremely negative overtones. This fact alone accounts for a lack of balance in the Journal story.

In addition, the Journal reporter was provided with all of the studies and the statistics on the SBIC program that I mentioned earlier in my testimony. The studies indicate that thousands of small SBIC portfolio firms are growing rapidly, developing new products, contributing increased federal tax payments, and creating jobs at a phenomenally low cost to the Federal government; the statistics show that SBICs are disbursing funds at record rates. None of this was mentioned in the article.

The reporter went beyond casting the entire story in a negative frame, however; in several instances he seriously misrepresented the program. For example, with this statement: "The program ...furnished $14 million in low-interest, taxpayer-backed loans to a group of well-heeled investors and Hollywood stars", he implied that these wealthy individuals were the the end users of the funds. As you know, Mr Chairman, this is not the case. Not only were the funds channeled through the SBIC directly into small growth businesses, but in order to obtain any leverage in the first place these individuals had to put their own private capital at risk. To those who call the program a "subsidy for rich investors", I can only reply that the benefits to the economy are far greater when these individuals put their money into the most innovative, job-creative segment of the economy through the SBIC program than when they invest in non-productive tax shelters.

I would also like to remind those who may have gotten the opposite impression from the Journal article that SBICs do not receive "government-subsidized loans". Although it is true that SBICs pay less than market rates for the money they receive from the Federal Financing Bank, they do pay fully the cost of money to the Treasury plus a small premium. Therefore, SBIC leverage presents no direct cost to the Government.

A reading of the Journal piece could easily leave an uninformed reader with the impression that there are virtually no rules governing SBIC activity. In fact, Mr. Chairman, nothing could be further from the truth. Over 100 pages in the Code of Federal Regulations are devoted to the SBIC program, covering every aspect of business operations. In addition, the SBIC program is the only SBA undertaking that requires each company to be examined annually. These yearly audits are similar to those that the Comptroller of the Currency conducts of commercial banks.

The regulations provide the Investment Division with the authority and the tools to punish regulatory offenders. If an exam report reveals that a company is not in compliance with the rules, immediate corrective actions are taken by the Investment Division. Not only are violators refused any leverage while their violations are outstanding, but repeated violators are transferred to the Office of Portfolio Management for liquidation and surrender of the SBIC license.

No matter how tough the precautions, there will always be some individuals who do not heed the law. They should be dealt with accordingly. My point is just that these few do not represent the industry as a whole.

The Journal article said: "Regulations are permissive about who may set up an investment company." However, officials at the Investment Division have always had the authority to approve only those who were qualified to manage an SBIC. In December of 1981, the experience requirements for SBIC managers were expanded. Now, all applicants must have at least 5 years successful experience in a position of responsibility involving business investment. In addition, if the SBIC plans to specialize in a specific industry, the manager must be experienced in that industry as well.

Mr. Chairman, rather than devote any more time and attention to the Journal article, I would simply like to ask that our industry's record be allowed to speak for itself. Anyone familiar with the work SBICs are doing, and the impact they are having on the economy, knows that the Journal did not present the true story.

LEVERAGE

As a final point in my testimony I would like to address the issue of SBIC borrowings from SBA, generally referred to as "Leverage."

It is apparent that our industry will need an increased amount of borrowings from SBA during the coming months. Under present law, SBA will be able to guarantee only $160 million in leverage in fiscal 1983 and 1984. At the same time, almost $155 million in outstanding SBA leverage will mature in fiscal 1983 and another $86 million in fiscal 1984. Under Federal budget accounting procedures, the "rollover" or refinancing of these maturing debentures counts as if they were new loans; thus, the present ceiling on fiscal 1983 leverage could be virtually exhausted merely by a rollover of maturing leverage, leaving no borrowing ability for new licensees or for those SBICs which have not drawn down the dollars to which they are entitled by law.

I mentioned earlier the pace of new investments by SBICs in 1981 and 1982, when nearly $700 million was invested. Leverage helped make this pace possible as has new money and the capitalization of realized gains by SBICs. But as we see the leverage picture today, with the Adminstration proposing to cut it back to $125 million, and only $135 million of last year's appropriation of $160 million used by SBA, and the funding of rollovers being at very high levels, it is clear that the new money pumped into small business will decline dramatically in the years ahead unless corrective action is taken.

"Squeezing out has been given as a reason for cutting back funding from the Federal Financing Bank for our program. I submit that our funds from that source are being used to allocate money to those companies who can use it most effectively and are least likely to receive it from normal sources.

So it is really not squeezing out, but letting some people in.

Mr. Chairman, as we testified before your Committee in February, NASBIC believes that the industry could use as much as $200-250 million in new leverage in fiscal 1983, in addition to the amount which will be required for refinancing maturing leverage. But, because of impending budget deficits, we recognize the need to place reasonable limits on all Federal programs. For that reason, we support an authorization level in the range provided by S. 2408. We thank the Chairman and the members of the Committee for their continued backing of our program, and we are hopeful the remaining roadblocks in the legislative process can be overcome to achieve authorization and appropriation levels in the range of $225-250 million for fiscal years 1983 and 1984.

The availability of leverage is essential to the continued growth of the SBIC industry. If it appears that SBA will not be able to fill the needs of eligible SBICs for leverage, very few individuals or institutions will organize new SBICs and very few existing SBICs will increase their private capital. Obviously, such a scenario will impact most adversely on entrepreneurs seeking SBIC dollars to start new businesses and on owners of smaller firms requiring venture capital to expand their companies to bring new products and new services to the American economy.

Conclusion

In conclusion, I would like to express my opinion that small business will more than likely lead the country out of the current recession. The SBIC industry is committed to providing growth capital to emerging small firms which create new jobs, launch new technologies and build productive capacity into America's economic system. Given the necessary resources, we are prepared to do that job.

I appreciate the opportunity to testify at this hearing. Thank you.

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DECEMBER 16, 1982

TESTIMONY

OF

E. PATRIC JONES, PRESIDENT

OF

THE URBAN FUND OF ILLINOIS

AND

CHAIRMAN OF THE AMERICAN ASSOCIATION OF MINORITY ENTERPRISE SMALL BUSINESS INVESTMENT COMPANIES

before the

SENATE SMALL BUSINESS COMMITTEE

Good Morning Mr. Chairman and members of the Committee. My name is E. Patric Jones, President of The Urban Fund of Illinois and newly-elected Chairman of the American Association of Minority Enterprise Small Business Investment Companies (AAMESBIC).

The Urban Fund of Illinois, which was incorporated in March of 1971, is owned by Hyde Park Bank and Trust Company, The First National Bank of Highland Park, and Marina Bank. We have completed thirty-seven financing to date, totalling approximately $3.5 million. Our MESBIC dollars have been the equity base for some $26.4 million in total financing of minority businesses. Many of our investments involve fast food franchises. The Urban Fund was in fact the catalyst in developing the largest fast food franchise in the country, a chain of seventeen Burger Kings. We do, however, invest in other areas including manufacturing companies, a $10 million paper distributor and a cable TV franchise. Through much luck and hard work, our MESBIC has managed to consistently generate profits. In addition, since 1971, our investment dollars have maintained or created approximately 3,200 jobs--most of which have been in the inner city.

MESBICs, which are authorized under the Small Business Investment Act of 1958, as amended, to invest in minority-owned small businesses, are responsible for the creation or maintenance of over 52,000 jobs over the past five years. Utilizing the unique public/private sector partnership of the MESBIC industry, these investors have been able to support the creation of business enterprises and jobs, very often in inner-city areas, where other fundings sources refuse to venture. In 1981 alone, MESBICs invested $54.4 million in minority enterprises, triggering an additional $109 million from other private sector sources, for a total available capital pool of over $163 million. Over the past five years, this multiplier effect has resulted in total capital investment of $600 million.

The industry has worked hard to reach the point at which we can boast of these achievements. Over $120 million of private capital and countless years of effort of MESBIC executives genuinely dedicated to the goals of the MESBIC program have been spent on these achievements. Thus, we support SBA wholeheartedly in their efforts to maintain the integrity of the industry by regulatory policies, which act as a deterrent to those who join the MESBIC industry for other than the intended purpose.

It is for this reason that we have been working especially hard at maintaining an open dialogue between our regulators at the Small Business Administration and our industry members. SBA Investment Division officials have always played an important role in our annual conventions. The sessions they take part in have provided a convenient forum for the exchange of information between the investors and the regulators in the program. In addition, AAMESBIC recently began a series of regulatory roundtables. These meetings are on a regional basis, and thus provide a smaller, more informal atmosphere for MESBIC executives to meet with their regional chiefs and other national officials of SBA's Investment Division and discuss issues of concern. Our first such roundtable was held in New York on December 2, and both the MESBIC executives and the SBA officials that attended expressed a high degree of satisfaction with the progress that was made at the meeting.

The prospect of the formation of an SBIC Advisory Council is also being discussed. This would provide a representative board of MESBICs, SBICs and portfolio concerns as an information source to the SBA. We support this step as further progress in strengthening the public/private sector partnership of the program.

Among the issues we have been working with the SBA on are the recently proposed changes in the SBIC/MESBIC regulations. In their originally proposed form, many of the changes were extremely objectionable to the industry. However, through our dialogue with the SBA, we believe we have been able to come to a series of proposed positive compromises on most issues. I would, however, like to take this opportunity to comment on a few of the proposed regulations, and how we believe they would affect the industry in their present form.

AAMESBIC believes that the implementation of the SBA's proposed regulations would have a disastrous impact upon MESBICs, their investees, and would ultimately result in the insolvency of the SBIC program. First, the SBA would radically change the cost of money as it related to the potential yield a MESBIC might earn on its investment in small business concerns. At the same time, SBA has proposed a mandatory extension of the maturity dates on the instruments used to finance these same small business concerns. SBA would mandate specific provisions requiring MESBICs to finance small business concerns on a subordinated and unsecured basis. At the same time, SBA would mandate these requirements which reduce SBIC profitability, the SBA would radically tighten its own credit policies with respect to MESBICs.

Clearly SBA, through its regulations, would put at risk approximately $110 million of private investors' funds now invested in MESBICs. These funds were raised by the MESBICs based upon the set of regulations which now exists and the investors' feelings they could operate within them. The changes proposed by the new regulations would create a totally new environment that the investors would have had no part in creating. SBA would give the investors no alternative nor chance to extract themselves from the SBIC program to allow them forced insolvency or regulated insolvency. SBA can not expropriate the capital of the SBIC's and MESBICs for its own interest and use without giving in turn some reciprocal benefits. For instance, we believe strongly that if the SBA desires to have the portfolio concerns which the MESBICs and SBIC's finance receive lower cost funds, the SBA must provide the operating licensess capital at a lower rate. That is the only fair and reasonable way to reduce the cost of money to small business concerns. Further, we believe that if SBA sincerely desires to have small business concerns have longer maturities on their funds, SBA must in turn provide to the MESBICs and SBIC's debenture instruments which themselves have a longer maturity.

We have raised several of these issues with SBA's Investment Division, and feel that we are making progress in reaching reasonable and economically sound compromises. The Investment Division has been receptive to our ideas, and we are optimistic about many potential changes in the proposed regulations, and about our general working relationship with the SBA.

INVESTMENT PHILOSOPHY

When the MESBIC program was created administratively in 1969, its intented purpose was to provide assistance to minority-owned firms. However, in 1972, Congress mandated that MESBICs would invest in businesses owned by socially or economically disadvantaged persons. The MESBIC program has come under fire for providing assistance to minority entrepreneurs some may consider of questionable eligibility.

The definition of "socially or economically disadvantaged" was established by Congress, and the SBA established investment guidelines within that definition. It only makes sense that MESBICs would seek out the most viable entrepreneurs within those classes. It is important to understand that the investment company industry looks to entrepreneurs and business opportunities that have the greatest chance for success. It is absolutely essential that MESBICs have the flexibility to invest in individuals who have the potential to make good business decisions and can operate in a business climate. Any other attitude would doom the program to failure and do a greate disservice to the minority community.

Secondly, the logic behind questioning the eligibility of minorities on the basis of a means test that does not apply to the regular SBIC industry is unclear. In a recent SBA Legal Opinion published in the October 1982 SBIC Digest, it was stated that "Vietnam era veterans are 'disadvantaged' without regard to wealth, race, or ethnic background". I fail to see the investment logic in this policy, and suggest that perhaps it is time for Congress to reevaluate its definition of eligible participants in the program.

LEVERAGE

In recent years, the industry has faced a variety of leverage situations. In 1979, there was an extreme shortage of leverage dollars, and many prospective deals went unfunded due to the lack of funds. In 1980, the industry appropriations were increased, and we we able to drawn down needed funds from the SBA. In 1981, we were temporarily put in the position of being totally stricken from the budget. It took months of hard work and strenuous efforts by the industry to re-install the program funds in the budget. The Administration has recommended an increased level of funds for the MESBIC program for fiscal year 1983. Congress seems to be in agreement with that recommendation. The point here is that the industry is on a veritable roller coaster from year to year. We make long term investment decisions, and in order for the industry to continue developing long term investment strategies and seek out additional private capital, there must be continuity and understanding of the public sector's role in the equation. The partnership concept can only function efficiently if the public sector partner realized that the leveraging of funds must be accomplished in a timely and business-like manner.

I would also like to take this opportunity to ask the Committee's support on another issue that has changed over time. In the early stages of the MESBIC progam, a provision was made in SBA's regulations for the leverage of federal and state funds invested in the program as a part of a general minority business effort. Over $17 million in public funds were invested, and for several years, the SBA leveraged those funds. Then in July of 1980, the Comptroller General issued a decision that it considered all public funds ineligible for SBA leverage. The SBA abruptly halted all public funds leveraging. Thus, millions of dollars in public and private sector funds have been invested in the program on the basis of a regulatory provision that the SBA abruptly decided to honor no longer. Undoubtedly, had the possibility of this occurrence been known ahead of time, these funds may have been used for other purposes. We feel that SBA reneged on a prior agreement by taking this action against the leverage of public funds. Therefore, we feel it only fair and equitable that all public funds invested in the MESBIC program prior to the Comptroller General's Decision be considered the SBA as eligible for leveraging, provided that all other leverage requirements are met.

The inequity of this situation has been recognized by the U.S. District Court for the District of Columbia in its recent decision in favor of public funds leverage, and by the House of Representatives, which passed a public funds leverage amendment earlier this year. Yet, the SBA has taken no actions to rectify the situation, and has in fact done the opposite. When the Investment Division published its proposed regulatory changes in August, it issued a regulation prohibiting the leveraging of public funds that was effective immediately.

REGULATORY VIOLATIONS

In February of 1980, the Inspector General's office issued a report on the SBIC industry based on a survey of SBICs over a three year period beginning in July of 1976. The report centered around what was referred to as the "significant six" regulatory violations. Several points must be made regarding this report.

First, the Inspector General's Report covers alleged regulatory violations. It is the SBA Investment Division's role to go through these reports and determine which violations it deems as truly significant. In fact, recent experience has proven that well over one-third of the "significant violations" cited by the Inspector General are not found to be significant after further investigation by SBA's Investment Division. Yet, the Inspector General never corrects his statistical findings to reflect this fact.

Secondly, the report is based on a three year period beginning in July of 1976. Some of the data being utilized is now over six years old. We find it of questionable judgement to make allegations based on such out-dated information. It would be much more useful if the Inspector General would report findings on an annual basis, utilizing more realistic statistical analysis.

However, since the Inspector General has been keeping statistics on the industry for several years, perhaps it would be most efficient to go back to past violators, concentrating on those SBIC's with a history of violations. It has been proposed that the mandatory audit cycle for SBICs be changed from one to two years, giving the Inspector General's office more time to concentrate on the less financially sound SBICs. We agree with this proposal to the extent that it would enable the Inspector General's office to target its energies on those SBICs which have demonstrated by documented evidence that consistent serious regulatory violations exist. We are concerned, however, that a two-year audit cycle could possibly impede many investment companies from receiving leverage in a timely manner because an examination had not been conducted within a stated period of time.

Further, we question the policy of the Inspector General in making recommendations that have such far-reaching impact without making itself accessible to the industry to discuss its policies. In fact, during many of its SBIC audits, the Inspector General's Office has made recommendations on findings that are clearly not regulatory violations. Yet when we recently invited them to take part in our industry-sponsored regulatory meetings, aimed at eliminating regulatory violations in the industry, the Inspector General's Office declined our invitation.

We believe it is important that those persons who enter the industry with fraudulent intentions be removed from the industry. We applaud the Inspector General's Office in its efforts to prevent industry abuse, and we would like to be able to work with them in their efforts.

IDLE FUNDS

The Management Advisory Report developed by the Inspector General's Office in October of 1981 addresses the issue of inactivity and idle funds in the SBIC program. In order to provide background on this issue, a historical perspective on idle funds must be presented.

During the early years of the MESBIC program, the MESBIC's private capital base averaged approximately $150,000. As operating entities, we did not have the capital wherewithal to adequately undertake the task assigned of providing equity capital to high risk minority concerns and also support the internal operations of the investment companies. Clearly the industry needed to have some assurance that once private capital was invested in a MESBIC, there would be sufficient operating funds to pay its day-to-day opeating expenses.

The SBA and Congress, desirous of a strong MESBIC industry, agreed that the industry should have access to sufficient low-cost capital to assist in the support of their operating expenses. It was decided that SBA, upon licensing a MESBIC, would provide to that MESBIC one tier of leverage, assuming the MESBIC met all other qualifications, matching dollar for dollar the private paid-in capital of the MESBIC. Therefore, MESBICs had the assurance at that point of adequate capital to make their riskier investments and to maintain a staff.

First dollar leverage in the form as outlined continued within the industry until 1980. At that point, SBA had a severe liquidity crunch when the actual capital requirement of the MESBIC industry exceeded the available appropriation during that year. SBA then decided that many of the MESBICs had achieved a level of private capital which allowed them to sustain their own operations. Therefore, in order to increase the availability of capital to those MESBICs which were in desperate need of capital for additional investments, the SBA decided in 1981 to discontinue altogether the practice of first dollar leveraging. Since 1981, MESBICs have been required by the SBA to expend 60% of their private paid-in capital before they could draw down any leverage from the SBA. This action by the SBA accomplished several things. First, it eased the leverage shortage and increased the availability of capital for those MESBICs who needed capital; secondly, it reduced the level of idle funds held by newly licensed MESBICs.

The SBA's procedure for providing operating stability and capital for MESBICs, therefore, resulted in what is presently termed MESBIC Idle Funds. "Idle Funds" are defined as capital held in short-term investments, which could be invested in small business concerns.

The Inspector General's Office has proposed in their Management Advisory Report that SBA's leveraging process be changed in order to reduce idle funds. Specifically, they propose the provision of an investment line of credit in place of the current process. The system would require an SBIC to notify SBA when 65% of its available capital has been invested and that it intends to apply for leveraging. Thereafter, the SBIC would be granted a line of credit consistent with its eligibility, but funds would be advanced only on a deal-by-deal basis, subject to SBA approval.

The industry can only be effective to the extent that it can close on its investment when an appropriate closing date occurs and not when SBA might be able to disburse funds as recently proposed in the recommendations of the Inspector General. We believe that such a structure would significantly reduce the flexibility and credibility of the MESBIC program and hence reduce the number of financings which are done annually by the industry.

It is AAMESBIC's contention that in fact funds provided the industry by the SBA are actively being invested in small business concerns. Many older MESBICs have received large infusions of private capital and many new large MESBICs were licensed within the last four years. These increases in private capital coupled with the paydown of prior loans made by MESBICs to small business concerns have boosted the assets of MESBICs available for reinvestment. As a result MESBICs have increased the level of investments made in each of the last four years. MESBIC investments during the last four years totalled 163,000,000 or 88% of their aggregate average assets during that period of time. Further, MESBICs because of the nature of their financing, oftentimes will accrue and maintain on hand, funds sufficient to pay SBA's interest on debentures when due. To pay dividends to the SBA when due, funds are also reserved to retire from time to time maturities of SBA's debentures. Should idle funds be eliminated in their entirety from the industry, the industry would lack then the capacity to maintain funds in sufficient amounts to pay its current obligations.

Had the Inspector General done a more careful analysis of the MESBIC industry, he would have found that idle funds can be stratified and can be rather easily explained by looking at MESBICs in terms of their age. our analysis of the industry which is based upon a random telephone survey of 30% of existing MESBICs shows that those MESBICs that were five years and older had a substantially lower idle funds balance as a percentage of their total capital than thsoe MESBICs that were relatively new. While the newer MESBICs averaged 36% in idle funds, those that had been in the industry for over five years had an average of 14% of capital in idle funds. The essence of that is that the MESBIC industry has shown tremendous growth in the number of companies over the last four years. All who are in the MESBIC industry recognize that it takes a considerable amount of time to develop a deal flow, and with that development, funds must be held in anticipation of consummating investments that the new management of the MESBIC is able to identify. But over time, it is clear, the idle funds position of the MESBIC diminishes as the size of a portfolio increased. This is a true and consistent occurrence. Across the board, the older MESBICs have a much lower idle funds position.

MESBICs maintain their idle funds position to cover the short-term needs of their companies. In fact, a proportion of investments made by the SBIC and MESBIC industry are made to existing portfolio concerns. Given the nature of our economy and its up and down-swings, many of our companies have had to be recapitalized. Funds must be maintained by the MESBIC to cover this occurrence.

Therefore we believe that there are specific reasons why the industry idle funds balance is not a static balance. It represents commited funds to existing portfolio companies, funds being maintained on hand because of the long lag in processing (in some cases over 90 days) before a company can expect a draw-down from the SBA, and it represents funds which are held by companies that are new to the industry who are in fact in the process of building their deal flow. The SBA cannot look at these funds at a point in time and state specifically that these funds are idle and not being put to good use.

One of the things that is not clearly presented in the Inspector General's report is that MESBICs are private companies. As private companies, should a loss be sustained, it is the loss of private capital that is first and not SBA capital. We believe that the structure as proposed by the Inspector General would result in a substantial increase in the losses of private capital and that the rate of creation of new MESBICs and new licensees and the willingness on the part of Corporate America, and private investors who have invested the bulk of the capital in MESBICs, to provide additional funding for existing MESBICs would soon disappear under the proposed SBA procedure.

In conclusion, we feel that the SBA is working with the industry in a cooperative fashion to maintain the integrity of the program. We believe this should be the Investment Division's primary focus and we feel they are making significant strides in this direction. However, we believe the SBA should be cautious in issuing regulatory policies that have a far-reaching and long term negative impact on the industry. The followong two examples of recent SBA policy changes illustrate this point.

In March of 1981, the SBA imposed a 90 day licensing moratorium on SBICs. This action was taken in order for the new Administration to review problems in the program. The result, however, was to stop many applications in progress and cause companies with private capital that had been committed to the program to decide not to pursue their interest in the industry. In addition, it caused unnecessary panic among existing licensees who failed to see the rational behind this move.

In addition, the SBA instituted a policy of having Small Business Administration Regional Officials interview license applicants to determine if they would be in competition with the institutional lenders already present in the community. On the surface, the policy may have seemed like a good idea, but it ended up adding three to six months to the licensing process. This additional delay is due to the fact that the SBIC program is centralized, and many regional officers are not familiar with important aspects of the program. In addition, reports submitted by regional officers were often not done properly and had to be resubmitted.

These two policies resulted in unnecessarily long licensing delays. As an example, International Paper Company, a nationally-known corporation, was forced to wait an entire year to receive its MESBIC license.

Once again, we would like to commend the Inspector General's Office and the Investment Division in their efforts to protect the credibility of the SBIC program.

Thank you for the opportunity to speak before your Committee today. I would be happy to answer any questions you might have.

**AMERICAN ASSOCIATION
OF MINORITY ENTERPRISE
SMALL BUSINESS INVESTMENT COMPANIES**
915 15th Street, N.W., Suite [illegible]
Washington, D.C. [illegible]
(202) 347 [illegible]

DECEMBER 16, 1982

TESTIMONY
OF
PATRICK OWEN BURNS, PRESIDENT
OF
MINORITY EQUITY CAPITAL CO., INC.
AND
LEGISLATIVE CHAIRPERSON OF THE
AMERICAN ASSOCIATION OF
MINORITY ENTERPRISE SMALL BUSINESS
INVESTMENT COMPANIES

before the

SENATE SMALL BUSINESS COMMITTEE

Good morning Mr. Chairman and members of the Committee. My name is Patrick Owen Burns and I am president of Minority Equity Capital Company, Inc. (MECCO), and board member and legislative chairman of the American Association of Minority Enterprise Small Business Investment Companies (AAMESBIC).

MECCO, organized in 1971, presently has $2.6 million of private capital provided by seven investors/shareholders. The five original investors, Metropolitan Life Insurance Co., The Ford Foundation, the Episcopal Church, Interracial Council for Business Opportunity (ICBO), and an individual were subsequently joined by FNCB Capital Corp. (Citi Corp's venture capital arm) and IBM. MECCO has "taken down" $2 million of SBA leverage in preferred stock plus $500,000 of subordinated debentures. Over the years, MECCO has provided from its own resources, private capital and leverage dollars, over $5 million of financing to over 29 companies with economic activity and payrolls in some twenty states and the District of Columbia. MECCO's venture investments directly or in conjunction with other MESBICs triggered or served as the basis for over $50 million of additional capital, frequently for expansion. Our portfolio companies range from publishing, such as Essence, to radio and TV stations in a number of states including Tennessee, New York, Missouri, Pennsylvania, Georgia, and Indiana to manufacturing firms based in plants in Connecticut, Texas, New York and Vermont, serving a nation-wide customer network to distribution and retail chains as well as construction firms.

Evidence of the broad-based support the MESBIC industry has received from the private sector is shown in the attached chart, which lists 136 corporations that have invested in MESBICs, with the notable recent addition of International Paper Company, with private capital of $1 million.

Our previous testimony covered our concern over the interpretation of the definition of individuals who are eligible to receive MESBIC financing. Once again I feel it is necessary to stress the importance of understanding the nature of the MESBIC industry from the investor's point of view.

As investors, MESBIC executives want to insure that the kinds of companies they invest in can achieve some degree of growth and offer a product or service that is beneficial to society. We want to be able to invest in companies whose operators are knowledgeable about good management practices. In addition, we prefer that our investees have a substantial stock in the success and liability of the company.

When making investment decisions, we look at factors like the kind of money that will be necessary to make the company grow and assure stability, the financial and managerial responsibility we will have to accept, and the potential profitability of the company. The most essential factor, however, is people. We must examine the entrepreneurs' successes, and their failures, and they must be educated and trained.

Once we have invested in a concern, we continue to monitor many of these factors for other reasons, one of which is portfolio company valuations. Under present procedures, the value of a portfolio company is determined by the board of directors of a MESBIC. The MESBIC board of directors uses its best judgement in making these value determinations, based on such factors as the history of the company, industry trends, management, the cash position, earnings history, and others.

The Inspector General's Office, however, has tried to impose its own valuations on several MESBICs. We believe this is an intrusion of the government into the private sector area of the MESBIC partnership. Their responsibility is not to assign a valuation, but to decide whether the MESBIC's board of directors has used a reasonable process in reachings its conclusion. The Inspector General should be cautious in overstepping the boundaries of his authority.

Over the past five years, MESBICs have invested over $186 million in small business concerns. These investments were made in a wide variety of industries. We have broken down the industry distribution of investments over the past five years and attached this information to my testimony for your convenience. To give you an even clearer idea of the types of investments we make, I would like to give sample "success stories" from some MESBIC portfolio concerns.

Communications has become an increasingly important area of investment for the MESBIC industry. Recent technological advances and the availability of as yet unclaimed markets in largely minority areas make communications an especially attractive field for MESBIC investors. Our optimism about the field is, in fact, proving to be well-founded.

In 1978, KBLE, a cable television system in Columbus, Ohio, received start-up financing from a MESBIC. The system presently has 9,000 subscribers in a predominantly black area of Columbus, and is one of four franchises in the city of Columbus. KBLE offers locally-originated and other community programming services not otherwise available in the area. The system is in the process of expanding, and recently won a franchise in a black area of Seattle. It has further hopes of becoming significantly involved in the programming of cable services for minority communities nationally.

Seven years ago, a consortium of MESBICs invested in Unity Broadcasting in New York as a start-up venture. The entrepreneurs wanted to put together a news network with a black perspective to provide a format to black radio stations across the country. Today they not only serve 80-90 radio stations, they also own 5 stations, and are nationally recognized with affiliates in almost every major population center. In addition, Unity Broadcasting has applied for cellular radio licenses in 5 cities and is on the forefront of new technology.

As a final example of a MESBIC communications deal, I would like to mention Inner City Broadcasting. MESBICs provided that company with $300,000 to help them to acquire needed property. Their first major property, WBLS, in New York, is now one of the most successful radio stations in the country. Inner City is also owner/operator of stations in Los Angeles, Detroit, Chicago, and together with Unity Broadcasting, has been franchised to develop a cable system in the Queens sector of New York.

One of our most successful publications deals has been Essence Magazine. A group of MESBICs and SBICs invested in Essence in the early stages of financing, and provided further financing at a later stage, for a total investment of in excess of $1 million. Its present circulation is 700,000 and its advertising has reached the 1,000 page level. Essence is an especially important investment because it creates and reinforces a positive image of black women in the black community at the same time it serves as a communications link between corporate America and the black consumer. Essence has now expanded to include offices in Atlanta and Chicago and is exploring several avenues of diversification.

In the area of manufacturing, I would like to begin with a deal that was voted the outstanding MESBIC financing in this year's Capital Access Achievements Awards.

Since 1971, the Blackfeet Indian Writing Company has been manufacturing wood case pencils, ball point pens, and fine line and broad tip markers. In 1978, recognizing the need for additional capital, a MESBIC consortium purchased $600,000 of preferred company stock. An innovative financing plan enabled the company to raise the money, create an Employee Stock Ownership Plan, and retire existing indebtedness. A second financing in 1981, which involved several of the original MESBIC investors, allowed the Blackfeet Indian Writing Company to purchase Lindy Pen Company--the oldest ball point pen company in the country. Today, the company has annual sales of approximately $8 million. It employs more than 175 people and produces its goods on the Blackfeet Indian Reservation. Articles about the company have appeared in Forbes, Time, and in Nation's Business.

In 1972, a group of MESBICs helped to Finance Golden Oak, a furniture manufacturing company in California. At one point, government contracts accounted for the majority of revenues, but the company now competes successfully on a national scale in the private contract furniture marketplace. Golden Oak builds high quality wood office furniture for major banks, savings and loans, law firms, Fortune 500 companies, and others. The company now has $7 million in sales and 140 employees. It endeavors to hire minorities for its predominantly semi-skilled jobs, and provides valuable training to these workers.

Finally, in the area of manufacturing, MESBICs invested several years ago in Cocoa Line Chocolate, Inc., a chocolate manufacturing company in Brooklyn. This company continues to generate substantial profits.

In the area of services, the MESBIC industry can boast of its investment in Boone, Young & Associates. This management consulting firm is one of the major contractors with the Department of Commerce's Minority Business Development Agency program to provide guidance counselling and general business assistance to minority concerns across the nation. The firm has now expanded to the point where it has been able to acquire three small manufacturing companies.

MESBICs also invested in Systems Management American Corp., (SMAC), a computer software and design company that is the largest minority company in Virginia. When it received its original MESBIC investment in 1975, SMAC had 40 employees and gross revenues of half a million dollars. The company now brings in more than $10 million in revenues and has more than 500 employees.

In what is believed to have been the largest equity-type financing to a Mexican-American-owned business in Texas, three MESBICs joined to provide over $1 million of debenture and common stock financing to Star/Adair Insulations, Inc., an oil field service company located in Odessa, Texas.

Star/Adair provides contract insulation work to energy companies in the Permian Basin, and through its offices in

Houston and in Grand Junction, Colorado, to oil refineries and natural gas plants from the Gulf Coast to Alaska. In addition, Star/Adair has two divisions that provide sheet metal and refractory services.

Started with $3,000 in 1967, the company now predicts sales of $18 to $20 million for 1982 and employs 400 people in four states.

The MESBIC industry continues to do the majority of its deals in the retail trade, and has been especially successful with food franchises. As my colleague mentioned earlier, his MESBIC played a part in developing the largest fast food franchise in the country. Many other MESBICs have invested in food franchises recognizing the management training and employment opportunities they offer--particularly to urban teenagers.

Our energy investments include a recent financing of Rapid Water Energy Co., Inc. The company, whose headquarters is in Boston, Massachusetts, is developing four low-head hydro power projects in Pennsylvania. The total project, which received MESBIC dollars in June of this year, is expected to cost $120 million.

A recent real estate investment was made in Diamondhead, Inc. The project includes 2 acres in downtown Petaluma, California, with a subdivision of 53 condominiums for the elderly. Two of those condominiums will be donated to the city for its low cost elderly housing program. The project has generated approximately $125,000 in municipal permit fees, $2 million in construction costs, and will create a new tax base of about $4 million. The project will create jobs for the construction trade, use raw materials and finished materials, and products for furnishing the condos. The investment will be multiplied to $40 million through the supply and service pipelines of private industries.

These investment examples were taken from MESBICs across the country, and are meant to demonstrate the type of work the majority of MESBICs are doing, or at least trying to do. Admittedly, financially sound minority deals are not available in an abundance, but the MESBIC industry makes every effort to find those deals and provide them with assistance.

Thank you for this opportunity to testify. I would be happy to entertain any questions.

INDUSTRY DISTRIBUTION OF FINANCING (%of #/%of $)

	1981	1980	1979	1978	1977
MANUFACTURING	14.6 / 16.7	16.4 / 17.3	17.5 / 19.4	19.2 / 24.2	28.8
RETAIL TRADE	30.6 / 19.4	24.7 / 17.8	28.8 / 17.5	29.8 / 22.3	19.0
SERVICES	13.6 / 13.1	15.2 / 11.3	15.0 / 11.2	18.4 / 18.6	18.0
WHOLESALE TRADE	4.2 / 5.4	5.7 / 4.8	6.1 / 5.2	11.0 / 8.3	9.1
FIN., INS., ESTATE	3.7 / 4.5	3.1 / 3.8	3.6 / 4.2	4.3 / 6.6	4.9
CONSTRUCTION	3.6 / 7.4	6.4 / 15.7	8.4 / 14.6	5.0 / 4.8	4.3
TRANS., COMM., UTIL.	23.4 / 26.4	22.5 / 24.3	12.9 / 18.5	4.3 / 4.6	7.0
ALL OTHER	6.3 / 7.1	6.0 / 5.0	7.7 / 9.4	8.0 / 10.6	8.9

INDUSTRY DISTRIBUTION (DOLLARS IN MILLIONS)

MANFACTURING	9.08	7.29	6.79	7.75	6.51
RETAIL TRADE	10.55	7.50	6.15	7.14	4.29
SERVICES	7.13	4.75	3.93	5.94	4.06
WHOLESALE TRADE	2.92	2.04	1.81	2.64	2.06
FIN., INS., R. EST.	2.46	1.62	1.49	2.11	1.10
CONSTRUCTION	4.01	6.62	5.14	1.53	.97
TRANS., COMM., UTIL.	14.36	10.24	6.49	1.48	1.58
ALL OTHER	3.85	2.11	3.30	3.40	2.03
ALL INDUSTRIES	54.36	42.17	35.10	31.99	22.60

The following companies have made significant investments in one or more MESBIC

Aetna Insurance Co.
Amerada Hess Corporation
American Heritage Life Insurance Co.
American Motors Corporation
American Petrofina, Inc.
Amstar Corporation
Armour-Dial, Inc.
Arthur Andersen & Co.
Ashland Oil, Inc.
Associated Finance (Gulf & Western)
Atlantic National Bank of Jacksonville (Florida)
Atlantic Richfield Company
Bank of America
Bank of Virginia
Barnett Bank of Jacksonville, N.A. (Florida)
Bell and Howell Company
Black Methodists for Church Renewal
Boston Urban Foundation
Burger King Corporation
Burroughs Corporation
Campbell Taggart, Inc.
The Catholic Church
Central National Bank of Chicago
Chase Manhattan Corporation
Chemical Bank (New York)
Christian Broadcasting Network
Chubb Corporation
Combined Insurance Co. of America
Commonwealth Edison Company (Chicago)
Continental Illinois National Bank & Trust Company of Chicago
Control Data Corporation
Convenient Industries of America, Inc.
Cooperative Assistance Fund
Cottman Transmission Corporation
Crocker National Bank
Electronic Data Systems Corporation
The Episcopal Church
Equitable Life Assurance Society of the United States
Fidelity National Bank of Baton Rouge
Field Enterprises, Inc.
Fireman's Fund Insurance Company
First National Bank of Boston
First National Bank of Commerce (New Orleans)
First National Bank of Dallas
First National Bank of Highland Park (Illinois)
First Pennsylvania Bank, N.A.
Financial Associates
Fluor Corporation
Ford Foundation
Ford Motor Company
General Foods Corporation
General Motors Corporation
Girard Bank (Pennsylvania)
Guaranty Bank and Trust Company of Alexandria, La.
Guaranty Bank and Trust Company of Lafayette, La.
Harding Associates
Hartford National Corporation
Hewlett-Packard Company
Humble Pipeline Company
Hyde Park Bank & Trust Company (Illinois)
IBM Corporation
I. C. Industries, Inc.
Illinois Tool Works, Inc.
Independent Life & Accident Insurance Company
Interlake Inc.
Irvinglake Inc.
Irving Trust Company (New York)
Interracial Council for Business Opportunity
International Telephone & Telegraph Corporation
Jacksonville National Bank (Florida)
Joe W. Brown Estate
Johnson & Johnson Company
John Hancock Mutual Life Insurance Company
John W. & Anna H. Hanes Foundation
Kaiser Aluminum and Chemical Corp.
Kresge's
Lomas & Nettleton Financial Corporation
MCA, Inc.
Maceabees Mutual Insurance Company
Marathon Oil Company
Manufacturers Hanover Trust Company (New York)
Marcor, Inc.
Marina City Bank (Illinois)

Marine Midland Banks, Inc.
Metropolitan Life Insurance Company
Mobil Oil Corp.
Morgan Guaranty & Trust Co. of New York
National Can Corporation
New England Mutual Life Insurance Company
North American Rockwell Corporation
Northern Illinois Gas Company
Northern Trust Corp. (Illinois)
Olin Corporation
Opportunity Funding Corporation
Pan American Life Insurance Co.
Philadelphia National Bank
Phillips Petroleum Company
Prudential Insurance Company of America
Raskob Foundation
Republic National Bank of Dallas
The Riggs National Bank of Washington, D.C.
R. J. Reynolds Industries, Inc.
Mary Reynolds Babcock Foundation
Rockwell International Corporation
S. C. Johnson and Son, Inc.
Scott Paper Company
Sears, Roebuck & Company
Seattle First National Bank
Shell Oil Company
Society for Savings
Sohio Petroleum Company
Standard Oil Company (Indiana)
Standard Oil Co. of California
Stockton, Whatley, Davin & Co.
Sun Bank of Jacksonville
Sun Company Inc.
Swiss Colony Stores
Tech Mod Corporation
Trans Union Corporation
Travelers' Insurance Co.
Union National Bank of Arkansas
Union Oil of California
Union Planters National Bank of Memphis
University Computing Company
U.S. Trust Co. of New York
Valley Bank and Trust Company
Valley National Bank of Arizona
Varian Associates
Virginia National Bank
Wells Fargo Bank, N.A.
Winnfield Life Insurance Company
Worthen Bank & Trust Co. (Arkansas)
Wyly Corporation
Xerox Corporation
Zale Corporation
Zenith Radio Corporation

APPENDIX

LOWELL WEICKER, JR., CONN., CHAIRMAN

BOB PACKWOOD, OREG.
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R. MICHAEL HAYNES, CHIEF COUNSEL
ALAN L. CHVOTKIN, MINORITY CHIEF COUNSEL

United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

December 16, 1982

The Honorable William French Smith
The Attorney General
Department of Justice
Constitution Avenue and 10th Street, N.W.
Washington, D.C. 20530

Dear Mr. Attorney General:

Today the Senate Small Business Committee held an oversight hearing on the Small Business Administration's SBIC and MESBIC Programs. During the course of this hearing, testimony was presented by the SBA Inspector General concerning his office's investigation of the First Capital Corporation of Fort Worth, Texas, a licensed SBIC.

On June 29, 1981, the Office of Inspector General issued an investigative report in which it found that the First Capital Corporation had used a capital manipulation scheme involving the use of circular financings to make it appear that its private capital was much higher than was actually the case. The report concluded that the "Principals of First Capital and the principals of some small business concerns, conspired to defraud the Government through misapplication of funds and by submitting false statements in order to receive additional funds."

In December, 1980, after SBA commenced its investigation, John R. Payne and Harry S. Scaling, the principals of First Capital, returned all money borrowed from the Government, $3,725,000, and attempted to immediately surrender the company's SBIC license. Ironically, because the funds were returned early, the Federal Financing Bank gave Payne and Scaling a $681,129 discount.

The Inspector General subsequently referred this matter to the U.S. Attorney for the Northern District of Texas to determine whether prosecution was warranted. On October 19, 1982, the Office of U.S. Attorney for the Northern District of Texas, James A. Rolfe, issued a letter declining to prosecute. This letter cited the fact that although the SBA investigation resulted in a "fraud being uncovered", since the Government had suffered no monetary loss; a trial would be lengthy and complicated; and there was little likelihood of any substantial punishment being handed out if the defendants were convicted -- which in the opinion of the U.S. Attorney was doubtful, the matter did not merit prosecution.

Testimony at the hearing revealed that Mr. Rolfe, before his appointment to the position of U.S. Attorney for the Northern District of Texas, represented First Capital in this matter while it was being investigated by the Office of the SBA Inspector General. After his appointment to the position of U.S. Attorney for the Northern District of Texas, it does not appear that Mr. Rolfe recused himself from deciding on the merits of this case. If so, it is an obvious conflict of interest that should be promptly investigated and appropriate action should be taken.

Enclosed is a copy of the declination letter from Mr. Rolfe's office dated October 19, 1982. I am also enclosing a copy of the report of investigation on First Capital Corporation prepared by the SBA Inspector General.

If you require any additional information please do not hesitate to contact me, or R. Michael Haynes, Chief Counsel of the Committee, at 224-5175.

Sincerely,

LOWELL WEICKER, JR.
Chairman

Enclosures

United States Attorney
Northern District of Texas
10th & Lamar Street
Fort Worth, Texas 761

Oct 20 3 40 PM '82
OFFICE OF SECURITY AND INVESTIGATION
DALLAS, TEXAS

October 19, 1982

10/21/82
MC-2-9

Mr. Murry W. Reese
Office of Inspector General
U.S. Small Business Administration
1114 Commerce Street
Dallas, Texas 75242

Re: S.B.A./F.B.I. Investigation of First Capital Corporation, John R. Payne and Harry S. Scaling

Dear Mr. Reese:

This is to advise that I am declining prosecution of the matter involving the subjects First Capital Corporation, John R. Payne, and Harry S. Scaling. After a lengthy and comprehensive review of the investigative report in this matter compiled by investigators of the S.B.A., as well as additional investigation done by the Federal Bureau of Investigation, I have determined that the matter does not merit federal prosecution for several reasons. First and probably foremost, is the fact that the Government has not suffered any monetary loss as a result of the subjects' scheme in this matter. While I realize that is a result of the fraud being uncovered before any loss could be suffered, it is nevertheless a difficult problem which we would face in the trial of any case where we would be attempting to prosecute individuals where the Government can show no harm from their actions. In addition, even though various individuals have given various explanations for the transactions that took place and which were the subject of your investigation, such explanations would certainly tend to be very confusing and would make it a very difficult case for a jury to understand and comprehand were this case to be tried. Again, that alone may not be grounds for declining prosecution, but I feel a jury may simply be inclined to give up trying to understand the facts and find the defendants not guilty because the Government would have suffered no monetary loss.

Looking at the total picture of this case, I can only foresee that if a prosecution were brought, it would result in a lengthy, complicated trial with chances for successful conclusion very doubtful and with little likelihood of any substantial punishment

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being handed out to the defendants in the event they were convicted, because of the fact that the government has suffered no loss. In summary, I feel that there is simply no compelling federal interest involved in prosecuting the case in light of these various factors.

I do wish to commend the investigators for the S.B.A. who worked on this case so diligently. In my six plus years in this office I have seldom seen a more comprehensive and complete investigative report as has been prepared by the S.B.A. in this matter. I know it is difficult to see many hours of work and investigation not result in a prosecution. However, I feel that there is a certain deterrent effect to individuals such as Mr. Payne and Scaling simply by knowing that they were "caught" and that they will be much less likely to engage in such "free-wheeling and dealing" with government money in the future.

If you have questions or desire to ~~to~~ discuss the matter further with me I will be happy to do so. I have enjoyed working with personnel associated with the S.B.A. in this matter and look forward to doing so in the future.

Very truly yours,

JAMES A. ROLFE
UNITED STATES ATTORNEY

R. H. Wallace Jr.
R. H. Wallace, Jr.
Assistant United States Attorney

cc: Special Agent Lawrence M. Connelly
Federal Bureau of Investigation
402 U. S. Courthouse
Fort Worth, Texas 76102

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ALAN L. CHVOTKIN, MINORITY CHIEF COUNSEL

United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

December 16, 1982

The Honorable Raymond Randolph
Acting Inspector General
Small Business Administration
1441 L Street, N.W.
Washington, D.C. 20416

Dear Mr. Randolph:

On December 16, 1982, the Senate Committee on Small Business held an oversight hearing on the Small Business Administration's Small Business Investment Company Program. As you know, the Committee received testimony from Murray Reese, a special agent for the Office of Inspector General, and the principal officers of the First Capital Investment Company regarding investigative findings that the officers, John R. Payne and Harry S. Scaling, used circular financings to make fraudulent representations of increased private capital to SBA.

Although the Department of Justice initially declined prosecution of the First Capital case, I believe that the testimony of Reese, and the explanations of Payne and Scaling, which I found unsatisfactory, warrant a complete investigation of financings made by the company while a participant in the SBIC Program. I suggest that you coordinate this investigation with the Department of Justice.

Thank you for your attention to this matter. If there are any questions, please contact Mike Haynes, the Committee's Chief Counsel, at 224-5175.

Sincerely,

LOWELL WEICKER, JR.
Chairman

DELIVERED VIA MESSENGER 9:45 AM
2/2/83 (bh)

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R. MICHAEL HAYNES, CHIEF COUNSEL
ALAN L. CHVOTKIN, MINORITY CHIEF COUNSEL

United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

February 1, 1983

Robert F. Muse, Esquire
Stein, Mitchell and Mezines
1800 M Street NW
Washington, D. C.
20036

RE: SUBPOENA FOR THE ATTENDANCE OF FELIPE De DIEGO BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS ON FEBRUARY 3, 1983

Dear Mr. Muse:

The Committee's Chief Counsel has informed me of your written request that your client, Felipe De Diego, not be required to appear and testify before the Senate Committee on Small Business on February 3, 1983, concerning his activities in and the operation of the Feyca Investment Company, a licensee under the SBA's Minority Enterprise Small Business Investment Company Program.

As you are aware, Mr. De Diego previously appeared before the Committee on December 16, 1982, during an oversight hearing on this program. Although appearing pursuant to subpoena, both he and his counsel initially indicated that they were prepared to make "full disclosure" to the Committee. However, after being asked only one question regarding the findings of the SBA Inspector General and the Committee that Mr. De Diego had misused more than $132,000 of Feyca's funds for personal expenditures, Mr. De Diego's counsel stated that he would have to advise his client to invoke his Fifth Amendment rights because he (counsel) needed more time to familiarize himself with the matter.

As Mr. De Diego's new counsel, you now inform the Committee by letter dated January 28, 1983, that Mr. De Diego "will exercise his Fifth Amendment right not to testify before the Senate Committee." You requested that Mr. De Diego be discharged from his obligations under the subpoena, and that your letter serve in lieu of a public appearance by your client.

You also stated that Mr. De Diego was advised by you that "he may incriminate himself if he testifies."

In light of Mr. De Diego's decision to follow your advice and invoke his constitutional right not to incriminate himself by testifying, the Committee has decided to discharge Mr. De Diego of his obligation under the subpoena to appear before the Committee on February 3, 1983. However, you are advised that the Committee's findings and the findings of the SBA Inspector General regarding Mr. De Diego and the operation of Feyca will be forwarded to the Department of Justice with a recommendation that they be presented to and reviewed by a Federal Grand Jury.

Sincerely,

Lowell Weicker, Jr.
CHAIRMAN

BY HAND

LAW OFFICES
STEIN, MITCHELL & MEZINES
1800 M STREET, NORTHWEST
WASHINGTON, D.C. 20036

BASIL J. MEZINES
GLENN A. MITCHELL
JACOB A. STEIN
GERARD E. MITCHELL
MICHAEL G. CHARAPP
DAVID U. FIERST
RICHARD A. BUSSEY
ROBERT F. MUSE
CARLOS M. RECIO

(202) 737-7777

January 17, 1983

BY HAND

R. Michael Haynes
Chief Counsel
Senate Committee on
Small Businesses
Room 424
Russel Office Building
Washington, D.C. 20510

Re: Feyca Investment Company

Dear Mr. Haynes:

This is to confirm the points we covered in our telephone conversation this morning:

(1) This firm will be representing Feyca Investment Company and its principal officer, Felipe De Diego, in all further proceedings before the Senate Committee on Small Businesses. We therefore request that you and your staff correspond with us regarding further matters.

(2) We understand that Mr. De Diego is presently scheduled to appear before the Senate Committee on Small Businesses on February 3, 1983, and that you will reissue the subpoena calling for his attendance on that date.

(3) It would be very useful for us if we could have access to the Committee's rules of procedure and any resolution identifying its authority and purposes.

(4) You stated that you would provide us with the memorandum summarizing Mr. De Diego's statements to you and the staff investigator, Mark Smolonsky.

Thank you for your cooperation in these matters.

Sincerely,

Robert F. Muse

January 17, 1983

Robert F. Muse
STEIN, MITCHELL & MEZINES
1800 M Street NW
Washington, D. C. 20036

RE: FEYCA INVESTMENT COMPANY
AND FELIPE DE DIEGO

Dear Mr. Muse:

Thank you for your telephone call and letter of this date advising that your firm had been retained to represent the Feyca Investment Company and Felipe De Diego.

This is to confirm that the Committee has resbheduled Mr. De Diego's appearance before the Committee on February 3, 1983 at 9:30 AM. To insure his appearance, the Committee will reissue a subpoena for his attendance on that date, and you have requested that you be permitted to accept service of process on his behalf.

I understand that you have already been provided a transcript of the brief statements made by Mr. De Diego and his prior counsel at the hearing of December 16, 1982, and a copy of the Special Report on the Feyca Investment Company prepared by the SBA Office of the Inspector General.

As you requested, and to facilitate your review of this matter, I am enclosing copies of the following:

(1) a copy of a Committee staff memorandum of interview of Mr. De Diego on December 7, 1982; and

(2) a copy of the Committee's rules and procedures which are reprinted in and part of the Committee's Legislative Calendar.

Please contact me after you have had the opportunity to review this material.

Very truly yours,

R. Michael Haynes
CHIEF COUNSEL

RMH/bh
Enclosures

LAW OFFICES
STEIN, MITCHELL & MEZINES
1800 M STREET, NORTHWEST
WASHINGTON, D. C. 20036

BASIL J. MEZINES
GLENN A. MITCHELL
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MICHAEL G. CHARAPP
DAVID U. FIERST
RICHARD A. BUSSEY
ROBERT F. MUSE
CARLOS M. RECIO

(202) 737-7777

January 28, 1983

BY HAND

R. Michael Haynes, Esquire
Chief Counsel
United States Senate
Committee on Small Business
Washington, D.C. 20510

Re: Felipe De Diego

Dear Mr. Haynes:

You and I met in your office on January 19, 1983. During the meeting you identified a number of matters about which the Senators may interrogate Mr. De Diego when he is called to testify before the Senate Committee on Small Business on Thursday, February 3, 1983. You are also aware, I understand, that Mr. De Diego has been the subject of an investigation by the Inspector General's Office of the Small Business Administration.

The Inspector General's investigation, and the subject matters that you identified, required us to advise Mr. De Diego that he may incriminate himself if he testifies. For this reason, he is following counsel's advice and will exercise his Fifth Amendment right not to testify before the Senate Committee.

Given this, we respectfully request that he be discharged from any obligations under the subpoena and that this letter serve in lieu of a public appearance by Mr. De Diego. We believe it is inappropriate to require him to appear in public and be subjected to the embarrassment that often occurs when one asserts his Fifth Amendment right.

I bring this request to your attention at this time, so that the money the government will spend in transporting Mr. De Diego from Florida to Washington can be saved. Thank you for your prompt attention to this matter.

Sincerely,

Robt F Muse
Robert F. Muse

DELIVERED VIA MESSENGER 9:45 AM
2/2/83 (bh)

LOWELL WEICKER, JR., CONN., CHAIRMAN
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ALAN L. CHVOTKIN, MINORITY CHIEF COUNSEL

United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

February 1, 1983

Robert F. Muse, Esquire
Stein, Mitchell and Mezines
1800 M Street NW
Washington, D. C.
20036

RE: SUBPOENA FOR THE ATTENDANCE OF FELIPE De DIEGO BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS ON FEBRUARY 3, 1983

Dear Mr. Muse:

The Committee's Chief Counsel has informed me of your written request that your client, Felipe De Diego, not be required to appear and testify before the Senate Committee on Small Business on February 3, 1983, concerning his activities in and the operation of the Feyca Investment Company, a licensee under the SBA's Minority Enterprise Small Business Investment Company Program.

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As Mr. De Diego's new counsel, you now inform the Committee by letter dated January 28, 1983, that Mr. De Diego "will exercise his Fifth Amendment right not to testify before the Senate Committee." You requested that Mr. De Diego be discharged from his obligations under the subpoena, and that your letter serve in lieu of a public appearance by your client.

You also stated that Mr. De Diego was advised by you that "he may incriminate himself if he testifies."

In light of Mr. De Diego's decision to follow your advice and invoke his constitutional right not to incriminate himself by testifying, the Committee has decided to discharge Mr. De Diego of his obligation under the subpoena to appear before the Committee on February 3, 1983. However, you are advised that the Committee's findings and the findings of the SBA Inspector General regarding Mr. De Diego and the operation of Feyca will be forwarded to the Department of Justice with a recommendation that they be presented to and reviewed by a Federal Grand Jury.

Sincerely,

Lowell Weicker, Jr.
CHAIRMAN

BY HAND